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No. 73

In the Supreme Court of the United States

OCTOBER TERM, 1962

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

FEDERAL POWER COMMISSION,
PHILLIPS PETROLEUM COMPANY,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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OPINIONS BELOW

The opinion of the Court of Appeals, Docket Nos. 16175, 16177 and 16180, issued on November 30, 1961 (R. 410-430) is not yet reported. The Federal Power Commission's Opinion and Order Determining Cost of Service and Terminating Proceeding, issued on September 28, 1960 (R. 251-341), and its Order Denying Applications for Rehearing, Amending Opinion and Rejecting Application for Rehearing, issued on November 25, 1960 (R. 395-404), in the proceeding entitled *In the Matters of Phillips Petroleum Company*, Docket Nos. G-1148, et al., are

reported at 24 FPC 537 (1960) and 24 FPC 1008 (1960), respectively. The decision of the presiding examiner, issued on April 6, 1959 (R. 35-217), in the same proceeding, is reported at 24 FPC 590 (1960).

JURISDICTION

The judgment of the Court of Appeals was entered on November 30, 1961 (R. 431-432). The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. § 1254(1) and Section 19(b) of the Natural Gas Act.[1]

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821-833 (1938), as amended, 15 U.S.C. §§ 717-717w (1958), and other statutes involved, are set out in Appendix A to this Brief.

QUESTIONS PRESENTED

(1) Where Sections 4 and 5 of the Natural Gas Act provide a standard of "just and reasonable" for the testing of rates of natural gas producers, may the Federal Power Commission terminate a producer rate proceeding instituted under said statutes and allow the rates at issue to become effective without a finding relative to their justness and reasonableness?

(2) Where the Court of Appeals, affirmed by this Court, has ordered the fixing of rates in accordance with the "just and reasonable" standard of the Natural Gas Act, may the Federal Power Commission, in the remanded proceeding, terminate the proceeding without fixing the rates as so ordered?

(3) Where the cost of service method of regulation is a lawful, established and effective means of regulating natural gas producers, may the Federal Power Commission abandon said method and substitute therefor interim regulation based on administrative fiat while it explores new procedures which it hopes will ultimately satisfy the requirements of the Natural Gas Act?

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1. 52 Stat. 831 (1938), 15 U.S.C. § 717r(b) (1958). (Appendix A, p. 10.)

(4) Where Sections 4 and 5 of the Natural Gas Act provide for the determination of just and reasonable rates for natural gas producers, may the Federal Power Commission promulgate a list of maximum acceptable rate levels, applicable to said producers, when this list was developed without notice, hearing, and the taking of evidence, and is fraught with practical infirmities?

(5) Where spiral escalation clauses in a natural gas producer's contracts are unacceptable in principle and unlawful in a regulatory setting, may the Federal Power Commission refuse to reject rate increases based thereon?

(6) Where Congress has provided for the regulation of natural gas producers under the Natural Gas Act, may the Federal Power Commission by interminable delay prevent said regulation from becoming a reality and substitute further experimentation for the presently valid standards of regulation?

STATEMENT OF THE CASE

A. ORIGINAL PROCEEDINGS BEFORE THE COMMISSION AND THE COURTS.

On October 11, 1946, the City of Detroit, Michigan, filed a motion with the Federal Power Commission (Commission) requesting that Phillips Petroleum Company (Phillips), an independent producer of natural gas, be declared a natural gas company subject to the Commission's jurisdiction and be made a party to the proceeding entitled *Michigan-Wisconsin Pipe Line Co.*, Docket No. G-669. In acting on this motion, the Commission said:

> "We believe that whether Phillips is or is not a natural gas company cannot properly be determined in this proceeding. If such a determination is required it should be made a separate case after a thorough investigation of Phillips' operations and we therefore find that the motion of the City of Detroit should be dismissed." *Michigan-Wisconsin Pipe Line Co.*, 6 FPC 1, 26 (1947).

On October 28, 1948, the Commission instituted an investigation to determine (1) whether Phillips was a natural gas com-

pany within the Commission's jurisdiction, and (2) if so, whether Phillips' existing rates were unjust and unreasonable. (R. 17-20). This investigation, designated Docket No. G-1148, was initiated pursuant to Section 5(a) of the Natural Gas Act.[2] On January 19, 1950, the State of Wisconsin filed a complaint with the Commission seeking to expedite administrative proceedings respecting Phillips' rates.

Hearings in the investigation commenced on April 3, 1951, and were directed solely to the jurisdictional issue. On August 16, 1951, the Commission found that Phillips was not a natural gas company within the meaning of the Act and, in accordance with this finding, terminated the investigation. *Phillips Petroleum Co.*, 10 FPC 246 (1951).

The United States Court of Appeals for the District of Columbia Circuit, on May 22, 1953, reversed the Commission and ordered it to "fix the rates at which these sales [by Phillips] are made." *State of Wisconsin v. Federal Power Commission*, 205 F.2d 706, 712 (D.C. Cir. 1953). This Court, on June 7, 1954, affirmed the judgment of the Court of Appeals. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

B. REMANDED PROCEEDING BEFORE THE COMMISSION.

In compliance with the judicial mandate the Commission, on November 23, 1954, resumed its investigation. (R. 407-409). This time the investigation was focused on the second issue—the justness and reasonableness of Phillips' rates.

By later orders the Commission consolidated with the Section 5(a) investigation twelve docketed rate increase filings of Phillips under Section 4(e) of the Natural Gas Act,[3] which increases had been suspended, but at the time were being collected subject to refund.

The new hearings began on June 26, 1956, and were conducted intermittently before a presiding examiner until December 18,

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2. 52 Stat. 823 (1938), 15 U.S.C. § 717d(a) (1958). (Appendix A, p. 3.)

3. 52 Stat. 823 (1938), 15 U.S.C. § 717c(e) (1958). (Appendix A, p. 2.)

1957. The hearings consumed eighty-two days and produced over 20,000 pages of record. (R. 44). Thirty-one parties intervened in the case. Therefore, the Commission's first effort to regulate the rates of a major natural gas producer began eight years after the original order instituting the investigation and eighteen years after the enactment of the Natural Gas Act.

In the course of the proceeding, and in its briefs and oral argument, Phillips took the position that its just and reasonable rates should be determined under the conventional cost of service method. (R. 60). At no time did Phillips contend that the cost approach, as applied in producer rate cases, was unworkable, or that it presented unduly complex problems. On the contrary, Phillips said: "While there was disagreement among the parties with respect to specific matters, there was complete unanimity with respect to many of the fundamental principles which serve as the starting point for any method of cost allocation." (R. 62). In the proceeding Phillips made a comprehensive cost of service presentation of the type consistently introduced in utility rate cases.

C. THE EXAMINER'S DECISION.

On April 6, 1959, the presiding examiner issued a 329 page decision in the consolidated proceeding. At the beginning of his decision the examiner reviewed the court and Commission decisions which he considered governed the case. He quoted paragraphs from *Interstate Natural Gas Co. v. Federal Power Commission*, 331 U.S. 682 (1947), and *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954). (R. 50-51). Then he observed that "there have been two major Court of Appeals decisions dealing with the broad problem as to how 'just and reasonable' rates should be determined for such producer sales under the Natural Gas Act": *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (D.C. Cir. 1955), and *Bel Oil Corp. v. Federal Power Commission*, 255 F.2d 548 (5th Cir. 1958). (R. 51-59). He also cited the Commission's opinion in *Union Oil Co. of California*, 16 FPC 100 (1956), and a number of other

cases to show that "the Commission has consistently held in numerous independent producer rate cases that the conventional rate base method of rate making must be used as a basis of comparison or point of departure." (R. 57)

The examiner then turned to some of the major contentions made by those opposed to the use of the cost of service method for the regulation of producer rates, noting at the outset that "Phillips itself has taken the position throughout this proceeding that its 'just and reasonable' rates should be determined under the cost-of-service method, rather than under a field price method." (R. 60).

To the contention that the four year delay in implementing the Supreme Court's *Phillips* decision is evidence that the cost of service method is unworkable, he replied that it was not until June, 1956, in the present proceeding, that any producer attempted to make "a comprehensive cost-of-service presentation." (R. 63). To the contention that the length of the hearing and record demonstrates its unworkability, he replied that "once the Commission has firmly established the applicable standards and methods to be used in determining producer rates" it will not be necessary to explore alterative proposals on such issues as allocation methods and the treatment of taxes or to present "voluminous general, industry-wide data and material * * *". (R. 64-65).

To an assertion that producers' records do not contain "the type of data required to develop a true cost of service and to make the necessary allocations," the examiner replied that Phillips was able to produce the necessary data and that similar difficulties in regulating pipelines had been solved "by the adoption of such techniques as a Uniform System of Accounts * * *." (R. 65-66). To the contention that allocation problems in connection with joint product wells are "complex," he replied that complex allocation problems had been solved in regulating integrated pipeline companies, and he cited examples. (R. 66-73). He observed further that "[t]he courts have never regarded the cost of service method for regulation of pipeline rates as being unworkable or unsatisfactory because complex allocations were

required, or because such allocations were not susceptible to mathematical exactness." (R. 70-71).

The examiner adopted a system-wide rate approach. Under this approach uniform rates were proposed for all customers, based upon Phillips' system-wide cost of service with rate differentials provided to reflect four different delivery condition factors. These four differential factors were: (1) point of delivery; (2) pressure; (3) whether dehydrated or undehydrated; and (4) whether sweet or sour. (R. 160-161).

The examiner rejected as "unacceptable" the area pricing proposals advanced by the Commission staff and others. (R. 161-180).

In adopting the system-wide rate approach, the examiner concluded that it represents "a satisfactory and appropriate method" for the determination of just and reasonable producer rates for the following reasons:

(1) "It is inherently simple to administer."

(2) "It would be fair to the producer, in the sense that it permits him to recover his total cost of service in one way or another."

(3) "It would eliminate unreasonable preferences currently enjoyed by pipelines which are still purchasing gas under old, abnormally low-priced contracts—preferences which are based not merely upon differences in cost levels, but which reflect other historic reasons."

(4) The examiner said that although a system-wide rate would require pipelines such as Panhandle Eastern Pipe Line Company (Panhandle) and El Paso Natural Gas Company (El Paso), which are presently paying "abnormally low prices," to pay a higher price, this would be only a temporary disadvantage. The examiner stated that such would be "counter balanced" by the fact that their necessary purchases of additional gas reserves from more recently developed and higher cost areas would be made at lower rates than would have resulted under an area pricing method. (R. 186-187).

The examiner stated that "the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future rate proceedings * * *." (R. 65).

The decision called upon Phillips to calculate new rates, based on a cost of service of $57,280,218, for each of its current jurisdictional rate schedules. These "calculated rates", if approved by the Commission, would constitute maximum rates for the consolidated Section 4(e) filings.

The examiner's decision demonstrated that just and reasonable rates could be developed for a producer of natural gas—in this case the nation's largest—on a cost of service basis.

Oral argument was held before the Commission on October 1-2, 1959.

D. THE COMMISSION'S OPINION.

On September 28, 1960, a three member Commission[4] issued Opinion No. 338 (R. 251-341) which reversed the decision of the examiner. The Commission terminated ten of the twelve Section 4(e) rate increase proceedings and the Section 5(a) rate investigation. Phillips was formally discharged from any obligation to make refunds.

The Commission said that its experience with producer rate cases had shown "beyond any doubt" that the cost of service method was "not a sensible, or even workable method of fixing rates of independent producers of natural gas." (R. 256).

"Since the cost rate base method seems almost always to produce the higher rates, it appears that consumers, in most instances, will be thoroughly protected if we place more reliance on existing prices and on applicable economic principles," the Commission said. (R. 265).

4. Participating members were Chairman Kuykendall, Commissioner Stueck and Commissioner Kline. The fourth member, Commissioner Sweeney, joined the Commission after the case was nearly completed, and did not participate. The fifth position on the Commission was vacant at the time.

Pointing to the backlog of producer filings, and considering incoming ones in the years ahead, the Commission concluded that even if the size of its present staff were tripled it could not catch up with its workload until the year 2043. (R. 263).

Besides this administrative burden, the Commission indicated that the cost of service approach "will penalize the efficient or fortunate producer and will unduly reward the inefficient or unfortunate producer." (R. 257). Furthermore, the Commission said, such an approach would result in "the extremely difficult problem" of allocating costs between regulated gas and unregulated oil when they are produced in conjunction. (R. 259).

The Commission observed that where landowners lease land to producers in return for a percentage of the price the producers receive for the products extracted therefrom, the cost approach might encourage leasing to the higher cost producers. (R. 261).

Having made these statements, the Commission abandoned the cost of service method for setting prices. The Commission announced that it would establish prices for the gas itself, and not for each individual producer. (R. 265-269). The ultimate goal as expressed by the Commission, would be:

> "[T]o set prices in all producing areas which will be adequate to maintain the gas supplies needed by the consumers of the nation, but at prices that are no higher than are necessary to accomplish that purpose." (R. 266).

And the Commission added:

> "We fully realize that some persons will contend that the plan of rate regulation we here announce is not lawful and that we are bound by *City of Detroit v. F.P.C.*, 230 F.2d 810 (CADC, 1956), *certiorari denied* 352 U.S. 829, to calculate a rate base and determine a rate of return, at least as a point of departure. If the contention is correct, then, as a practical matter, adequate regulation of producers appears to be impossible under existing law." (R. 267).

Despite the Commission's several contentions as to the drawbacks of the cost approach, it adopted that very approach in the instant proceeding, though not to the point of making a decision.

The Commission explained that it was using cost of service because this was "clearly a lawful way to determine rates for Phillips as illustrated by the *City of Detroit* case, and under the present record is the only possible method, and therefore we shall make every effort to reach a result by this means." (R. 269). Moreover, the Commission said: "In the present proceeding we are as a matter of law permitted to reach results by this method." (R. 270).

The Commission found that Phillips' revenues for the test year 1954 fell about $10,000,000 below the $55,548,054[5] cost of service which the Commission computed for that year. (R. 325-326). Because of this deficiency in revenue, the Commission excused Phillips from making refunds respecting ten of the twelve Section 4(e) increases. This action was taken, the Commission said, because nine of the ten dockets had been superseded by new filings for even higher rates and that the now locked-in rates which were before the Commission should be bypassed. This resulted in putting the proposed increases into effect without setting any rates. As the Commission stated: "[I]t would appear that on the basis of the present record that Phillips' costs probably exceed its revenues at least up through the year 1958, after which very substantial further rate increases were filed by Phillips." (R. 329).

Upon this assumption that Phillips did not recover its cost of service through 1958, the Commission invited Phillips to move to dismiss other Section 4(e) proceedings "on the theory that little or nothing would be accomplished if hearings were held and a determination of Phillips' costs in each case were made." (R. 329). The Commission said this would have the effect of limiting future proceedings dealing with Phillips' rates to the year 1959 and later. Presumably, these later rates would be governed by an area pricing scheme.

Three of the consolidated Section 4(e) dockets concerned rate increase filings based on the activation of spiral escalation

5. On rehearing, this figure was changed to $54,525,315. (R. 400-401).

clauses.[6] Docket No. G-11217, involving a sale to El Paso, and Docket No. G-10883, involving a sale to Panhandle, were left open pending the final determination of the rates of these pipeline companies in other proceedings. However, the rate increase in Docket No. G-10793, covering a sale to Michigan-Wisconsin Pipe Line Company, was approved by the Commission. (R. 328-329). By keeping the former open only on the issue of the amount of increase and by approving the increase in the latter, the Commission placed a stamp of legality on spiral escalation clauses.

The Section 5(a) general investigation of all of Phillips jurisdictional sales was terminated without decision because the Commission did not "think that it is appropriate to set rates for the future on the basis of this record in this hearing that terminated December 18, 1957, utilizing a test year of 1954 or 1956 * * *" (R. 271), and because Phillips' "customers and consumers will receive the protection of our area pricing standards announced at this time" (R. 325).

The Commission disapproved of Phillips' spiral escalation clauses "in principle" yet refused to declare them void in this proceeding. (R. 327).

One Commissioner dissented, but only with respect to the manner in which the cost of service was computed.

The Commission's Statement of General Policy—In accordance with its opinion, the Commission simultaneously issued its Statement of General Policy No. 61-1 (Policy Statement). (R. 343-348). The Policy Statement is concerned not only with producer matters under Sections 4 and 5, but also producer certificates of public convenience and necessity under Section 7 of the Act.[7] It divides part of the continental United States into several producing areas, with two price guides or "maximum acceptable rates" for each area. (R. 344). One price is for new

6. Spiral escalation clauses are discussed in detail on pp. 56-61. See also Appendix B, this Brief.

7. 52 Stat. 824 (1938), 15 U.S.C. § 717f (1958). (Appendix A, p. 4).

sales which must be certificated under Section 7. The other price is for increases under existing contracts. Prices on new sales will be conditioned if they do not conform to the area price for new gas; price escalations in existing contracts will be suspended if they do not conform to the area price for established service.

The Policy Statement provides for area rate proceedings wherein parties may challenge the price levels or the geographical makeup of the area. (R. 346-347). The Commission did not disclose the basis for the particular levels and said only that the Policy Statement was "based on our experience gained after six years of regulation of independent producers under the Natural Gas Act." (R. 343).

E. THE ORDER DENYING REHEARING.

California filed a timely petition for rehearing on October 28, 1960 (R. 363-370), which was denied by the Commission on November 25, 1960. (R. 395-404).

In the order denying rehearing the Commission said it terminated the proceedings without making the finding as to the justness and reasonableness of Phillips' rates as required by Sections 4 and 5

> "because we did not believe we were supported by the record in doing so [making a finding], and we were of the opinion that the public interest did not justify our continuing these proceedings. In the first place we are given discretion as to whether to initiate proceedings either under Section 5(a) and Section 4(e). * * *
>
> "Just as the statute leaves us with discretion as to whether to initiate proceedings, we have authority to discontinue the proceedings. Regulation under the Natural Gas Act is carried on in the public interest (Section 1(a)), and there is no obligation to continue these proceedings to the point of making a definitive finding with respect to Phillips' rates, where the public interest is not served." (R. 395-396).

The Commission concluded:

> "[T]he attempt here to regulate Phillips' rates on an individual company basis has proved cumbersome and inexact.

> It has demonstrated however, that there is no public interest in continuing the Section 4(e) proceedings, which are largely concerned with past periods. Furthermore, because of the lapse of time, the 1954 cost of service determined by us is not appropriate for the future. The more recent rate increases filed with us have been suspended under Section 4(e), and they will be subject to the new area methods of regulation discussed in our Policy Statement." (R. 397).

The Commission refused to rule that the spiral escalation clause in Phillips' contracts were void as against public policy.

F. PROCEEDING IN THE COURT OF APPEALS.

Pursuant to Section 19(b) of the Natural Gas Act,[8] California obtained court review of the Commission's opinion and the order denying rehearing.

The court, with Judge Fahy dissenting with partial concurrence, upheld the Commission's position that the cost of service method of regulation is not a sensible, or even workable, means of fixing producer rates. (R. 414). It pointed out, as did the Commission, that cost of service, by limiting producers to a fair return on investment, penalizes efficient or fortunate producers who have low costs. (R. 414). The method, the court said, produces problems in the allocation of costs between gas and oil and is a burden on the administrative agency. (R. 414-415). Nevertheless, the court agreed with Phillips' cost of service as computed by the Commission. (R. 419-420).

The court divided the proceeding into three parts. The first part of the problem, as the court saw it, concerned the nine Section 4 (e) dockets which had been superseded, or locked-in, by a new series of rate increase proposals.[9] The court said:

> "In these 4(e) cases * * * the Commission was dealing with a locked-in period. The revenues derived from the

8. 52 Stat. 831 (1938), 15 U.S.C. § 717r(b) (1958). (Appendix A, p. 10).

9. The court also included within this grouping a tenth docket, G-8623, which had not been superseded by a filing for a higher rate. (R. 325).

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> rates at issue had been impounded. The only question of substance in respect to that period was whether refunds should be made." (R. 419).

Accordingly, the court concluded that the Commission's action in terminating these dockets was a clear decision, after elaborate findings, upon the issue of refunds. (R. 420). The court further said that "[w]hether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries." (R. 420).

The second part of the problem was what the court called "the determination of rates for the future." (R. 421). The court found that the Commission was justified in abandoning the Section 5(a) investigation "in which it had been endeavoring to establish rates for the future by methods it now deems inadequate." The court also approved the inauguration of the area pricing scheme. (R. 421).

The third and final part, in the court's view, was the "interim period" from January 1, 1959, to a date uncertain when the area pricing of gas is ultimately established. (R. 421-422). It is acknowledged that this period may last as long as fourteen years. (R. 422). To carry on its duties during this period, the court said that the Commission could rely on the rates established by the Policy Statement. The court expressed the problem this way:

> "Can [the Commission] adopt upon the basis of its own expertise and its files, without a record made in the open in respect to the specific subject matter in issue, and without hearing, a set of guide lines by which it will be controlled in its regulatory functions during an interim period which it is attempting to perfect a suitable system for permanent regulation? We think it can." (R. 422).

On the question of the legality of Phillips' spiral escalation clauses, the court said:

> "Wisconsin and California contend that the Commission should now declare these escalator clauses to be illegal and

> void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, insofar as these clauses of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission." (R. 426-427).

The court was referring to the spiral escalation clauses in Dockets Nos. G-11217 and G-10885, which dockets were left open on the issue of the amount of increase only. The court made no reference to the spiral escalation clause in Docket No. G-10795, which docket was not left open but was terminated along with the other Section 4(e) proceedings.

The dissenting opinion did not agree that the termination of the Section 4(e) and the Section 5(a) proceedings should be affirmed. The dissenting judge said: "I think the cases should be remanded to the Commission for decision." (R. 427). On the cost of service issue, Judge Fahy noted:

> "In the same breath as it were in which it describes the unworkability of the cost of service method the Commission itself accepts that precise method in finding that no refunds are to be required in the Section 4(e) proceedings * * *." (R. 427-428).

Speaking of the Commission's proposal to establish commodity pricing of gas on an area basis, he said:

> It is one thing to say, as the Commission does, that the area method should hereafter be adopted, or even adopted in other cases which have not proceeded as far as those before us. It is quite another thing to say that the latter should not be decided under the standards of the Act because the area method was not used in preparing the record. Unless decided Phillips challenged rates are left undetermined under the standards of the Act since 1948, and apparently will continue to remain undetermined until some future day when new proceedings, now in an inchoate status with no end in sight, are concluded." (R. 429).

The dissent insisted that the primary purpose of the Natural Gas Act, that is, consumer protection, can be achieved by remanding the proceeding to the Commission, and supplementing the record as necessary. The dissent said:

> "The absence of a decision on the issue of justness and reasonableness of rates has the effect of leaving all rates subsequent to 1954 untested under the standards of the Act. Substance is not achieved merely by finding whether or not refunds were due on the basis of the 1954 data. A finding in that regard should not be independent of a finding of just and reasonable rates. The former should follow from the fact that the just and reasonable rates are not exceeded by those in effect." (R. 430).

The dissent concurred with the majority only as to the prematurity of the request for action relating to the spiral escalation clauses.

G. CALIFORNIA'S INTEREST IN THE CASE.

California's interest in this proceeding stems from its unique dependence upon natural gas as a fuel. Since California does not possess coal deposits sufficient for its energy requirements, it is compelled to rely upon natural gas. Ninety per cent of all homes in California are heated by natural gas and California industry depends upon natural gas as a fuel.

California commenced importing natural gas from out of state sources in 1947. In 1961 it purchased 765,483,478,000 cu. ft. of gas from El Paso at a cost of $257,854,417.54.[10] This represented over 80 per cent of El Paso's operating revenues. In the same year El Paso purchased 248,920,469,000 cu. ft. from Phillips at a cost of $38,732,594.75.[11]

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10. Annual Report of El Paso Natural Gas Company to Federal Power Commission for Year Ending December 31, 1961, FPC Form #2, Sales for Resale—Natural Gas (Account 483), pp. 521-522.

11. Annual Report of El Paso Natural Gas Company to Federal Power Commission for Year Ending December 31, 1961, FPC Form #2, Gas Purchases (Accounts 800-805), pp. 535-536.

From 1947 to 1960 the average producer price paid by El Paso increased from 2.8 cents per Mcf to 15.8 cents per Mcf, or almost 400 per cent.[12] Today the producer price makes up a substantial portion of the final price paid by the ultimate California consumer.

California ratepayers, numbering over 4,000,000, have a substantial interest in the effective regulation of Phillips, and of producers generally. California estimates that by 1970 it will be importing 1,825,000,000,000 cu. ft. of natural gas annually to serve an expanded population. The cost of this huge quantity of fuel will depend, as it does now, upon effective regulation of prices at the wellhead.

SUMMARY OF ARGUMENT

The primary purpose of the Natural Gas Act is the protection of consumers from exploitation at the hands of natural gas companies. In rate cases, like the instant proceeding, the Act is designed to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges.

In 1954, this Court found that the Commission had jurisdiction, under the Act, to regulate the rates of independent producers of natural gas who sell their product for resale in interstate commerce, and ordered the Commission to undertake such regulation. The Commission, however, has not complied with this mandate; rather, it has offered indecision, indifference and delay as alternatives to the effective regulation which this Court ordered. As a result of the Commission's inaction, consumers of natural gas have not received the protection to which they are entitled.

The instant proceeding was terminated without a finding on the substantive issue before the Commission—the justness and reasonableness of Phillips' rates—even though the Commission had conducted the case to the point of receiving an examiner's decision and hearing oral argument on the issue presented. This termina-

12. Annual Reports of El Paso Natural Gas Company to Federal Power Commission, 1947-1960, FPC Form 2, Gas Purchase Accounts 715.11 and 715.12 (excluding exchange gas) (Permian Basin).

tion was contrary to the judicial mandate to fix the rates at which Phillips' jurisdictional sales are made.

In terminating the proceeding, the Commission erred in abandoning the cost of service method of regulation. Cost of service is a lawful, established and effective means for determining just and reasonable rates for producers under the Natural Gas Act, and it has been consistently used by the Commission and repeatedly approved by the Courts. It was the conventional form of regulation at the time the Natural Gas Act was enacted, and the Act is specifically designed for its use. Furthermore, by assuring producers the recovery of their costs through rates, as well as providing a return on investment, it guarantees the producers their constitutional rights.

As a substitute for cost of service regulation the Commission visualized the eventual establishment of the commodity pricing of gas on an area basis. This, it recognized, may take as long as fourteen years. In the meantime, the Commission will operate under a so-called Policy Statement which was promulgated without notice, hearing, and taking of evidence, and which is subject to revision at any time in like manner. The maximum acceptable rates announced in the Policy Statement are admittedly not promulgated as just and reasonable rates and, therefore, are not necessarily lawful rates within the meaning of the Act.

The Policy Statement is fraught with practical difficulties in that it has the effect of raising otherwise lower rates to the established commodity price levels. It is also ineffective because of the right of producers to file for rate increases at any time regardless of these levels.

The Commission further erred in perpetuating the existence of the spiral escalation clauses in Phillips' contracts, even though the Commission itself was opposed to them in principle. These clauses, causing consumer price increases which are unrelated to the factors involved in producing gas, permit the exploitation of consumers in contravention of the Natural Gas Act.

Consumer protection requires that there be effective regulation of prices at the production end of the natural gas industry. The

decision of the Court of Appeals and the opinion of the Commission fail to provide such effective regulation and, accordingly, they must be set aside.

ARGUMENT

I.

Independent Producers Are Not Exempt From the Established Standards of Regulation Under the Natural Gas Act.

The Commission's opinion commences with this language: "This is a rate proceeding under Sections 4 and 5 of the Natural Gas Act * * *." (R. 251). But as the opinion develops it becomes quite clear that the Commission's approach is far different from that found in the usual rate decision in the usual rate proceeding. For the Commission's opinion takes the form of a bill of particulars as to why it cannot decide the case by known and established procedures and why it must terminate the proceeding before it and make a new start in other proceedings. (R. 256-269, R. 323-326)

A divided Court of Appeals recognized the instant case as one involving "major problems of general application" and posing "complicated procedural difficulties." (R. 411).

California, intervenor before the Commission and petitioner in the court below, has never characterized this case as being any more than a rate case that should be decided under the standards established by the Natural Gas Act. However, California does emphasize the paramount importance of this proceeding, for involved here are the rates of the largest natural gas producer in the nation and the procedures that will govern natural gas producers generally.

California contends that the Commission unlawfully used the instant proceeding as a vehicle for establishing rates and practices which are contrary to the Natural Gas Act and for approving contract provisions which are repugnant to public policy.

In Section 1(a) of the Natural Gas Act[1] the Congress made

[1] 52 Stat. 821 (1938), 15 U.S.C. § 717(a) (1958). (Appendix A, p. 1).

known the compelling reason for federal regulation of the natural gas industry:

> "As disclosed in reports of the Federal Trade Commission made pursuant to S. Res. 83 (Seventieth Congress, first Session) and other reports made pursuant to the authority of Congress, it is declared that the business of transporting and selling natural gas for ultimate distribution to the public is *affected with a public interest*, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is *necessary in the public interest*. (Emphasis supplied).

In natural gas regulation the public interest requires consumer protection. While the segments of the natural gas industry which produce, sell and transport this natural resource are constitutionally entitled to protection against confiscation, as are public utilities, the underlying basis of the congressional regulatory scheme is the protection of the consumer.

This Court emphasized that the primary aim of the Act is "to protect consumers against exploitation at the hands of natural gas companies." *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 611 (1944); *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 685 (1954).

This purpose was reaffirmed in *Sunray Mid-Continent Oil Co. v. Federal Power Commission*, 364 U.S. 137, 147 (1960), and rephrased in *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 388 (1959): "The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." See also *Federal Power Commission v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 19 (1961).

This standard of consumer protection must be weighed against the action of the Commission in this proceeding. Having determined Phillips' cost of service, the Commission said "the next step would ordinarily be to alter Phillips' rates to reflect this cost of service." (R. 323). But the Commission did not take this step.

Instead, the Commission took notice that Phillips had filed, since the instant proceeding began, for even higher rates, some involving "substantial increases." (R. 324). The Commission also noted that "costs and prices of gas in the field have greatly increased" since the proceeding commenced, though there is no record basis for this observation. (R. 324). The Commission concluded that it was "not appropriate" to continue its Section 5(a) general investigation now that the record was so old. (R. 324).

In brief, the Commission said: We will not decide whether the rates before us are proper under the Act because Phillips has filed for higher rates and, when the time comes, we will decide if those higher rates are proper. This reasoning is analogous to this Court saying: We will not decide this case because a case will arise in the future with the same issues, and we will decide that case at that time.

The termination, the Commission said, will not "substantially" injure Phillips' customers because Phillips' rates will be "subject to our continuing surveillance * * *". (R. 325). And the Commission added:

> "Additionally [Phillips'] customers and consumers will receive the protection of our area pricing standards announced at this time. Phillips will not be injured, for we are thus leaving in effect its contract structure; it has had the privilege of filing increased rates and has done so in substantial amounts as already noted." (R. 325).

It should be noted that the Commission said customers "will not be *substantially* injured" and Phillips "will not be injured." (Emphasis supplied). Thus, the Commission tipped the scales away from the standard of consumer protection.

The Section 4(e) dockets were terminated because "these rates have produced revenues less than Phillips' cost of service during the periods that they were in effect." (R. 325-326). Nothing of this sort was ever demonstrated because the particular rates were not altered to reflect the cost of service. (R. 326). What was shown was that the company's revenues were less than costs in

the test year. The mere fact that the company's over-all gas operations did not result in sufficient revenues does not mean that the rates themselves must be just and reasonable. By this reasoning Phillips could charge 1¢ per Mcf in one contract and $1.00 per Mcf in another contract, and if this caused a deficiency in revenues, then both rates would be just and reasonable. How then would those consumers who feel the impact of the $1.00 price, and not the effect of 1¢ price, be protected?

Continuing surveillance and a proposed area pricing scheme are not the complete, permanent and effective bond of protection to which consumers are entitled. Consumer needs are present, not future. Natural gas is a commodity which is being consumed daily by the industry of America and by its people. The clear intent of Congress in providing for protection against exploitation was present protection, not a deferral to some future providence. Consumer protection demands that the Commission decide the cases at issue before it, and decide them with due consideration to the injury they may cause to the ultimate ratepayers.

Congress has provided a standard, applicable to all natural gas companies, to enable the Commission to protect consumers. Section 4(a)[14] sets forth that standard:

> "All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission * * * shall be *just and reasonable*, and any such rate or charge that is not *just and reasonable* is hereby declared unlawful." (Emphasis supplied).

In *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 611 (1944), the Court found this section to be the "heart" of the whole regulatory scheme, and the pulsation of this heart must be heard in all rate proceedings, for this is what gives vitality to the regulatory process.

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14. 52 Stat. 822 (1938), 15 U.S.C. § 717c(a) (1958). (Appendix A, p. 1).

The captive consumer has no effective means by which he can escape the incidence of unjust and unreasonable prices. If he wants gas, he must accept the price set by the local distributing utility. The residential consumer cannot turn to other fuels without discarding his expensive gas appliances; the industrial consumer is often limited to natural gas by local air pollution regulations.

In California, the price fixed for the distributing companies is largely dependent on the price charged by El Paso, the major exporter of gas to California. El Paso buys a substantial portion of its supplies from Phillips. The Phillips' price, then, is critical to California. If it is not just and reasonable, its injurious impact is felt in California.

The Commission's action in terminating the instant proceeding, without determination of the issue of the lawfulness of rates, has the effect of exempting Phillips, and other producers, from the standards of consumer protection and just and reasonable rates, which are imbedded in the Natural Gas Act and enunciated by this Court.

II.

The History of Independent Producer Regulation Is One of Indecision, Indifference and Delay.

For a period of about sixteen years—from 1938, when the Natural Gas Act was enacted, until 1954, when independent producer regulation was ordered by this Court—the Commission regulated the rates of natural gas companies on the cost of service basis.[15] The cost of service method allows a natural gas company to recover its operating costs, including taxes, plus a return on its original investment, less depreciation. During this period the Commission persisted in the view that only interstate pipeline companies were natural gas companies and, consequently, only

15. The leading cases were: *Canadian River Gas Co.*, 3 FPC 353 (1942); *City of Cleveland v. Hope Natural Gas Co.*, 3 FPC 350 (1942); *Interstate Natural Gas Co.*, 3 FPC 416 (1943); *Cities Service Gas Co.*, 3 FPC 459 (1943); *El Paso Natural Gas Co.*, 13 FPC 421 (1954).

some thirty-seven major pipelines were included within the scope of natural gas regulation.

On November 17, 1954, almost six months after this Court's decision in the *Phillips* case, the Commission issued a notice of proposed rule making entitled "Consideration of Principles and Methods to be Applied in the Fixing of Rates to be Charged by Independent Producers of Natural Gas Sold in Interstate Commerce for Resale," Docket No. R-142, 13 FPC 1524 (1954). The Commission invited written comments and heard oral argument, but over twelve months later it terminated the proceeding without adopting a method indicating that such would have to come through a consideration of individual cases:

> "However, the information gained in this proceeding convinces us that, on the basis of the record herein, we should not lay down any rules as to what would be necessary or appropriate for consideration in determining the just and reasonable rates of any independent producer subject to our jurisdiction under the Natural Gas Act." 14 FPC 1128, 1129 (1955).

The attitude expressed there, seven years ago, rings familiar to the attitude which inconclusively terminated the instant proceeding.

In the first opinions issued in independent producer rate cases the Commission refused to announce any substantive rules of general application, thereby indicating its indecisiveness. For example, in *Wunderlich Development Co.*, 15 FPC 690, 693 (1956), the Commission said:

> "We do not pass on the question of whether evidence of the character now before us would in any other case substantiate a given rate as just and reasonable."

In *Davidor and Davidor*, 15 FPC 1236, 1238 (1956), this attitude is again shown:

> "We cannot say, in view of the uncertain and nebulous state of the applicable law, that proof of the character here submitted would justify a rate increase in all or any other similar case."

These decisions are startling because the Commission was not without guidance. In *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 616 (1944), this Court, referring to the method of regulation under the Natural Gas Act, said:

> "The Committee Report stated that the Act provided for regulation along recognized and more or less standardized lines and that there was 'nothing novel in its provisions.'"

The *Hope* case upheld the Commission's use of a net original cost rate base plus operating expenses, with no allowance for the value of gas as distinguished from the cost of production, in regulating the rates of a natural gas company engaged in *both production and transmission*.

The Commission itself, in *El Paso Natural Gas Co.*, 15 FPC 421, 426 (1954), had said that the rates for both independent producers and for pipeline companies' own production should be fixed in the same manner.

But the alarming element of the Commission's indecision is that the first independent producer rate cases were decided subsequent to the Court of Appeals decision in *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (D.C. Cir. 1955), cert. denied 352 U.S. 829 (1956). There the court had said, at page 818:

> "[Cost of service] has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful—just and reasonable—rates under the Act. *Unless it is continued to be used at least as a point of departure*, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning." (Emphasis supplied.)

Instead of following the guiding principles of the *City of Detroit* case, the Commission reacted against them. Typical of this reaction is the testimony of then Commission Chairman Kuykendall (one of the authors of the opinion in the instant proceeding) before a House Appropriations subcommittee:

> "CHAIRMAN KUYKENDALL: * * * I would say this, and with all due respect to the circuit court of appeals, I think that the court was in error when it told us we had to have an original cost study of each producer."[16]

With this indifference toward the guidelines pointed out to it by the courts, and toward its own prior experience in regulation, the Commission on June 26, 1956—two years after this Court's decision in the *Phillips* case—commenced hearings in the instant proceeding. It is interesting to note that the hearings were conducted along the cost of service lines called for by the *City of Detroit* case. And it was thought that the Commission would also follow that path to a decision when, in an order denying rehearing, it said:

> "What [Section 4] does require is the presentation of rate base and cost evidence as a point of departure plus a showing that any additional allowance is no more than is reasonably necessary for the purposes advanced for any increase." *Union Oil Co. of California*, 17 FPC 89, 91 (1957).

The Commission followed no path at all. In 1960 it terminated the instant proceeding with the result that producer regulation was set back to its 1954 status. Adding this six-year period to the sixteen years from 1938 to 1954, and adding to this total the time it has taken to bring this proceeding to this Court, it will soon be the twenty-fifth year in which the consumers of the nation have gone without the type of regulation demanded by the Natural Gas Act.

No discussion of Commission indecision, indifference and delay is complete without reference to other aspects of the Commission's reluctance to regulate independent producers.

The Commission has never established a uniform system of accounts and records for independent producers of natural gas. This Court has commented on the indispensability of such systems to effective regulation. *Interstate Commerce Commission v. Good-*

16. Hearings on the Independent Offices Appropriations for 1957, House subcommittee, February 20, 1956, at p. 1727.

rich Transit Co., 224 U.S. 194, 211 (1912); *Kansas City So. Ry. Co. v. United States*, 231 U.S. 423, 440 (1913). Moreover, this Court recognized the Commission's authority to prescribe uniform systems of accounts in *Northwestern Electric Co. v. Federal Power Commission*, 321 U.S. 119 (1944), and in *Federal Power Commission v. East Ohio Gas Co.*, 338 U.S. 464 (1950).

The thousands of independent producers, making up the largest single group within the Commission's jurisdiction, have not been subjected to a comprehensive uniform system of accounts and records even though the Commission recognizes the necessity of this for effective regulation. *The East Ohio Gas Co.*, 6 FPC 176, 183 (1947).

California, upon the apparent expectation that the Commission itself would act on this matter, did not formally request the Commission to enact such a system. However, on July 9, 1962, California filed with the Commission a Petition to Establish a Uniform System of Accounts and Records for Independent Producers of Natural Gas, which has been designated as Docket No. R. 220.

Another aspect of the Commission's disinclination toward producer regulation is the active support which it has given to legislation exempting producers from regulation, including the Harris-Fulbright Bill[17] which was vetoed by President Eisenhower in 1956.

The Court of Appeals' decision in the instant proceeding has only further delayed effective producer regulation. The court below spoke of the regulation of producers as a "new project." (R. 421). Furthermore, the court asked the nation to wait "four to fourteen" years more for the type of regulation which the Commission thinks will be desirable. (R. 422).

As already indicated, producer regulation is not a new project and the nation has already waited a quarter of a century for some action. The Commission could openly defy the judicial mandates and the dictates of the Natural Gas Act, but without success, if it were to announce its outright refusal to regulate the production

17. H.R. 4560, 84th Cong., 1st Sess. (1955); H.R. 6645 84th Cong., 1st Sess. (1955) (amended bill); S. 1853, 84th Cong., 1st Sess. (1955).

of natural gas. California asks whether or not interminable administrative indecision, indifference and delay are not tantamount to a refusal to regulate.

One of the greatest dangers of the administrative process is that an agency, through lethargy or other reasons, can thwart the aim of the legislation it is obligated to administer. This Court urged an agency to act "as quickly as is consistent with good administration." *National Labor Relations Board v. Electric Vacuum Cleaner Co.*, 315 U.S. 685, 698 (1942). See also *Smith v. Illinois Bell Telephone Co.*, 270 U.S. 587, 591-592 (1926).

Shortly after the Commission's opinion was issued in the instant proceeding, a special report to President-elect Kennedy on the regulatory agencies was released.[18] The document was prepared by James M. Landis, formerly dean of the Harvard Law School and formerly chairman of both the Securities and Exchange Commission and the Civil Aeronautics Board. The report is sharp in its criticism of the Commission. It states:

> "The Federal Power Commission without question represents the outstanding example in the federal government of the breakdown of the administrative process. The complexity of its problems is no answer to its more patent failures. These failures relate primarily to the natural gas field, in the Commission's handling of its responsibilities with respect to the transmission and the production of natural gas. Enough has already been said about the delays in this field, so terribly costly to the public and so productive of unemployment in other basic industries."

The Commission's dread of producer regulation is without foundation. For over twenty-four years the Commission has had subject to its jurisdiction and has regulated a large number of pipeline companies which are engaged in the exploration, development and production of natural gas in most of the same areas and fields in which producers conduct their operations. Moreover,

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18. Report on Regulatory Agencies to the President-elect, submitted by the Chairman of the Subcommittee on Administrative Practice and Procedure to the Committee on the Judiciary of the United States Senate (December, 1960).

many of these companies have producing-company subsidiaries or affiliates. It is difficult to understand the Commission's reluctance to do the full job in producer cases when it has been doing the same work for years in integrated pipeline cases.

III.

The Proceeding Was Unlawfully Terminated.

A. THE PROCEEDING CANNOT BE LAWFULLY TERMINATED WITHOUT A FINDING RESPECTING THE JUSTNESS AND REASONABLENESS OF PHILLIPS' RATES.

The Commission's Section 5(a) investigation was intended to be an examination of all of the jurisdictional rates of Phillips for the purpose of determining the lawfulness of such rates. The Section 4(e) proceedings were for the purpose of deciding whether the rates demanded in particular dockets were lawful rates. A lawful rate is any rate or charge that is just and reasonable. Section 4(a).

Section 5(a) fits into the scheme of natural gas regulation as a means, first, of determining the justness and reasonableness of existing rates and, second, of fixing just and reasonable rates for the future if existing rates are, in fact, not just and reasonable. Section 4(e), being less broad, is concerned with the justness and reasonableness of rates contained in specific filings. See *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 388-389 (1959).

California insists that a finding as to justness and reasonableness is required in the instant proceeding. It is immaterial whether the Commission uses the words "unjust and unreasonable," "just and reasonable," "not just and reasonable" or "not unjust and unreasonable." California does not insist on a verbal formula. The finding that the statutes demand is one relative to the justness and reasonableness of the rates at issue. If existing rates are just and reasonable, the Section 5(a) investigation must be decided with such a finding; if the same rates are unjust and unreasonable, a finding to that effect must be made, with the Commission further obligated to fix rates for the future. If the rates involved in the

Section 4(e) dockets are just and reasonable, or the contrary, they must be so found.

In its order denying rehearing the Commission said it was under no obligation to make "a definitive finding with respect to Phillips' rates * * *." (R. 396). The court below adopted this view. The court held that the making of such finding was unnecessary in the Section 5(a) investigation because the Commission could not continue the proceeding using "methods it now deems inadequate" (R. 421); and it was unnecessary in the Section 4(e) dockets because the only question of substance there was "whether refunds should be made" (R. 419). The court said:

> "Whether the Commission should have preceded its ultimate conclusion of no-refund with an intermediate conclusion of justness and reasonableness in the rates at issue, and whether it properly added the termination order to its decisive finding, seem to us to be immaterial queries." (R. 420).

In opposition to this position it must be pointed out, first, that an agency, such as the Commission, cannot take action without making the findings required by statute. *Mahler v. Eby*, 264 U.S. 32, 44-45 (1924); *City of Yonkers v. United States*, 320 U.S. 685, 689 (1944). The necessity for such findings has been discussed by this Court in *Colorado-Wyoming Gas Co. v. Federal Power Commission*, 324 U.S. 626, 631, 634 (1945):

> "Here as in the cases of Canadian and Colorado Interstate the findings of the Commission leave much to be desired. The findings are general and incorporate by reference the staff exhibits, on which reliance is put for the subsidiary findings. * * *
>
> "The review which Congress has provided for these rate orders is limited. Section 19(b) 15 USCA Sec. 717r(b) 4 FCA title 15, Sec. 717r(b) says that the 'finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.' But we must first know what the 'finding' is before we can give it conclusive weight. We have repeatedly emphasized the need for clarity and completeness in the basic or essential findings on which administrative orders rest. Florida v. United States, 282 US 194, 215, 75

> L ed 291, 304, 51 S Ct 119; United States v. Baltimore & O R. Co., 293 US 454, 464, 79 L ed 587, 594, 55 S Ct. 268; United States v. Chicago, M. St. P. & P. R. Co., 294 US 499, 504, 505, 510, 511, 79 L ed 1023, 1028, 1029, 1031, 1032, 55 S Ct 462; United States v. Carolina Freight Carriers Corp., 314 US 475, 488, 489, 86 L ed 971, 982, 62 S Ct 722. Their absence can only clog the administrative function and add to the delays in rate making. We cannot dispense with them for Congress has provided the standards for judicial review under this Act. Sec. 19(b). The courts cannot perform the function which Congress assigned to them in absence of adequate findings. Nor are they authorized under Sec. 19(b) to make findings and substitute them for those of the Commission."

Not only do the Natural Gas Act and the courts require findings but also the Administrative Procedure Act. Section 8(b)[19] of that Act requires that "All decisions * * * shall * * * include a statement of (1) findings and conclusions, as well as reasons or basis therefor, upon all material issues of fact, law, or discretion presented on the record; and (2) the appropriate rule, order, sanction, relief, or denial thereof." In the instant proceeding, Judge Fahy's dissent pointed to the absence of a finding on the issue of justness and reasonableness of the rates (R. 430), and concluded the case must be remanded to the Commission for that finding (R. 427).

Secondly, the court below and the Commission, by making the determination of refunds the primary question in a Section 4(e) docket, ignore the literal language of that section. Section 4(e) is designed to consider the lawfulness, that is, the justness and reasonableness, of filed rate increases. The provision for refunds, contained therein, is merely a means of accounting for amounts collected under thes filed rate increases while the issue of lawfulness is pending befo: the Commission in suspension cases only. Until a decision on the lawfulness of rates is made, the Commission cannot possibly know if any monies must be refunded.

19. 60 Stat. 242 (1946), 5 U.S.C. § 1007(b) (1958). (Appendix A, p. 12).

The substantial prejudice resulting to California from this insufficiency in findings is apparent. California has participated in this prolonged administrative proceeding to its great expense in time, energy and money. While this proceeding was in the hands of the Commission, rate increase was stacked upon rate increase, through no fault of California. California is entitled to a decision on the justness and reasonableness of the rates which were before the Commission; California should not be required to wait for new proceedings which will consider only Phillips' new rates.

Most importantly, this Court, in *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 391 (1959), has allowed the Commission, under Section 7 of the Natural Gas Act, to certificate initial prices in new sales by independent producers if they are not "out of line" with established price plateaus. The prices of Phillips, made effective by the order of termination in this proceeding, go into the price line which guides the Commission in Section 7 proceedings. By allowing prices that are untested under the standard of just and reasonable to enter the line can only distort the line, if not make it meaningless.

B. THE PROCEEDING CANNOT BE LAWFULLY TERMINATED ON THE BASIS OF UNLIMITED DISCRETION TO SO ACT.

The termination of the Sections 5(a) and 4(e) proceedings is controlled by *Minneapolis Gas Co. v. Federal Power Commission*, 294 F.2d 212 (D.C. Cir. 1961), where the court below found that the Commission had no discretionary authority to terminate a rate proceeding, without deciding it, after the examiner had rendered an initial decision, the parties had filed exceptions, and the Commission had heard oral argument. The decision in the instant case is clearly inconsistent with that holding. In the *Minneapolis Gas* case the court said, at page 215:

> "We think the Commission cannot terminate a proceeding after it has actually conducted a hearing to the point of receiving an Examiner's initial decision, without rendering a decision upon the issue presented * * *. [W]e are of the

> opinion that the Commission, having received all the evidence the parties wish to present, and having before it an Examiner's findings, conclusion and decision, cannot at that point change its mind, wiping out the hearing as though it had never occurred, and in effect decide it will not enter upon a hearing."

In the present case, the examiner made a decision on the issue before him. The parties filed exceptions; the Commission listened to oral argument. These facts are identical to those in the *Minneapolis Gas* case. Moreover, in the instant proceeding and in *Minneapolis Gas*, the Commission terminated the cases without a decision on the issue presented—the justness and reasonableness of rates. In *Minneapolis Gas* the court found that the Commission had no discretion to terminate at this point; the court should have made the same judgment in the present case.

In the order denying rehearing the Commission said: "[W]e are given discretion as to whether to initiate proceedings either under Section 5(a) or 4(e) * * * Just as the statutes leave us with discretion as to whether to initiate proceedings we have authority to discontinue proceedings." (R. 396). Judge Fahy, following the *Minneapolis Gas* case, recognized the error of this position:

> "The Commission says it has a discretion to terminate as well as to initiate; but once it has exercised its discretion to initiate and has pursued the matter to the extent we find here its discretion to terminate is not as broad as was its discretion to initiate. The former becomes limited by the conditions existing at the time of its exercise." (R. 429).

Having initiated a proceeding under statutory direction and judicial mandate, and having pursued such course through extensive and exhaustive hearings and briefs to the point of an examiner's decision, exceptions and oral argument, the Commission is without discretion to inconclusively and indecisively terminate.

By so terminating without making the finding respecting the justness and reasonableness of the rates at issue, the Commission not only asserted unlawful discretion but also achieved the same

result which would have obtained had it made a finding of justness and reasonableness in Phillips' favor.

In *Louisville & Nashville R.R. v. Behlmer*, 175 U.S. 648 (1900) and *East T. V. & G. Ry. v. Interstate Commerce Commission*, 181 U.S. 1 (1901), this Court remanded rate cases to the Interstate Commerce Commission because that agency ruled in favor of certain parties before deciding the statutory issue of just and reasonable rates. The Court held that the parties were entitled as a matter of law to a decision on all the issues in the cases.

In *Greensboro-High Point Airport Authority v. Civil Aeronautics Board*, 231 F.2d 517 (D.C. Cir. 1956), the Airport Authority asserted in hearings before the agency that carriers serving the airport were discriminating against it in favor of another city. In a final order, the agency failed to decide that issue. The court held that the agency was required by law to decide the issues in the cases before it and remanded the matter to the agency, with directions to decide the issue and state the reasons for its decision.

The assertion of unlimited discretion to terminate proceedings is inconsistent with the Natural Gas Act which imposed upon the Commission the administrative duty of deciding rates in accordance with the standard of justness and reasonableness.

Moreover, Congress did not intend that the Commission's power to conduct extensive proceedings should be governed by an unlimited discretion whereby the Commission may terminate them at any time without reaching a conclusion. Whenever Congress sets up a regulatory agency it uniformly confers broad powers for investigation and for conduct of proceedings. These powers are not mere matters of discretion but essential parts of the regulatory process. See *Smith v. Interstate Commerce Commission*, 245 U.S. 33, 43-45 (1917); *Schaffer Transportation Co. v. United States*, 355 U.S. 83, 89 (1957).

Under the rationale of the *Minneapolis Gas* case, the Commission was required either to permit the examiner's decision to stand or to render its own decision. Its order of termination is erroneous as a matter of law.

C. THE PROCEEDING CANNOT BE LAWFULLY TERMINATED IN CONTRAVENTION OF THE JUDICIAL MANDATE TO FIX PHILLIPS' RATES.

When the Commission in 1948 instituted the Section 5(a) investigation of Phillips' rates it did so, among other reasons, for the purpose of determining whether the rates were just and reasonable. (R. 17-20). The Commission did not reach this determination because it found that it had no jurisdiction over Phillips. However, on appeal the Commission was reversed. "* * * Phillips is a 'natural-gas company' within the meaning of the Natural Gas Act and the Commission should *fix the rates at which these sales are made.*" *State of Wisconsin v. Federal Power Commission*, 205 F.2d 706, 712 (1954). (R. 405-406). (Emphasis supplied).

In apparent compliance with this mandate, which was affirmed by this Court, the Commission reopened the proceeding. (R. 407-409). The Commission did not assert that the reopening of the proceeding was a matter within its discretion. No such assertion was made until the order denying rehearing was issued. (R. 396).

California contends that the Commission neglected or refused to follow the clear instruction of the Court of Appeals "to fix the rates at which these sales are made." (R. 406). The Commission, therefore, acted contrary to the intention of this Court, the Court of Appeals, and the parties to the proceeding that the instant case would continue until the justness and reasonableness of Phillips' rates had been decided.

IV.

The Cost of Service Method of Regulation Must Not be Abandoned.

A. THE CONVENTIONAL COST OF SERVICE METHOD PROVIDES A LAWFUL, ESTABLISHED AND EFFECTIVE APPROACH FOR EVALUATING INDEPENDENT PRODUCER RATES.

One of the most important and far-reaching aspects of this proceeding was the rejection by the Commission and the court below of the conventional cost of service method of fixing just and reasonable rates for independent producers. The rejection is based on the contention that cost of service is unworkable and produces ridiculous results. (R. 414). The Commission supported

this conviction on the basis of experience, which it did not particularize, gained since this Court's *Phillips* decision in 1954. The court below, in turn, upheld the Commission on the ground that the agency should not be bound "by methods it now deems inadequate." (R. 421). A review of court and Commission decisions, during the period following the enactment of the Natural Gas Act, demonstrates that cost of service is, in fact, a lawful, established and effective method of determining just and reasonable rates, and for these reasons must not be abandoned.

1. Application of Cost of Service in the Regulation of Natural Gas Companies Prior to 1954.

Prior to this Court's *Phillips* decision in 1954, there were three decisions respecting the criteria for the regulation of natural gas companies. In *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942), the question before this Court was whether the *Nebbia*[20] doctrine (that a state regulatory body may fix the prices charged by a business affected with a public interest so long as the price-fixing is reasonable, not arbitrary, and not capricious) could be applied to federal regulation under the Natural Gas Act. The Court held, at page 585, that the Commission could establish the "lowest reasonable rate" for a natural gas company and that this rate would not be confiscatory within the meaning of the Fifth Amendment. Moreover, the Court said, at page 586: "[T]he courts are without authority under the statute [Section 5(a)] to set aside as too low any 'reasonable rate' adopted by the Commission which is consistent with constitutional requirements." When the Court observed, at page 586, that the "Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas" the Court was only concerned with the constitutional requirement of due process. In other words, due process was not denied to the natural gas com-

20. *Nebbia v. New York*, 291 U.S. 502, 523-539 (1934).

party by the Commission's use of a particular formula in determining rate base."

In the *Natural Gas Pipeline* case this Court was not concerned with the non-constitutional problem of the limits of the Commission's statutory authority to apply rate making formulas. This is apparent from the following language found at page 586:

> "Agencies to whom this legislative power has been delegated are free, *within the ambit of their statutory authority*, to make pragmatic adjustments which may be called for by particular circumstances." (Emphasis supplied)

In the concurring opinion of Justices Black, Douglas and Murphy, it was pointed out, at page 600, that the "Commission has a broad area of discretion for selection of an appropriate rate base." The decision, then, does not authorize the Commission to use an approach other than the cost of service method but only indicates that the Commission may select what it considers the appropriate rate base under the circumstances. In all situations the Commission must stay within the ambit of its statutory authority.

The question of the scope of the Commission's statutory authority was raised in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). There the argument was raised that the Commission must set prices to discourage the industrial use of gas so that this wasting asset could be consumed for better purposes. The Court answered, at page 616:

> "Yet if we are now to tell the Commission to fix the rates so as to discourage particular uses, we would indeed be injecting into a rate case a *novel* doctrine which has no express statutory sanction." (Emphasis supplied)

Here this Court was pointing out that Congress authorized the Commission to determine rates in the traditional way and did not envision unusual procedures. Thus, the Court added: "Sec. 4(a) and Sec. 5(a) contain only conventional standards of rate making for natural-gas companies." Searching the legislative history of the Act, the Court further said, at page 616:

> "The Committee Report stated that the Act provided 'for regulation along recognized and more or less standardized lines' and that there was 'nothing novel in its provisions'."

It is beyond argument that the conventional, recognized and standardized means of regulation at the time the Natural Gas Act was passed was the cost of service method.

Several statements in the *Hope* case—"nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at" (page 603)—"The Commission was wholly justified in rejecting the latter [reproduction costs] as a measure of rate base" (page 605)—reveal that this Court also considered the cost of service approach to be the traditional method of regulation at the time of the Act, and to be the method by which Congress intended the Commission to regulate.

This consistent adherence to the cost of service approach by the Court is most strongly stated in *Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581, 602 (1945):

> "These provisions [several sections of the Act] all suggest that when Congress designed this Act it was thinking in terms of the ingredients of a rate base, the deductions which might be made, and the additions which were contemplated. * * * We must read Sec. 1(b) in the context of the whole Act. It must be reconciled with the explicit provisions which describe the normal conventions of rate-making."

In the 1954 decision in the *Phillips* case, this Court, recognizing the intent of Congress to regulate independent producers as natural gas companies, made no departure from the position that cost of service was the proper form of regulation under the Natural Gas Act. Consequently, the Commission's contention, in the instant proceeding, that it is not bound by the cost of service approach, is unsupported by law.

2. Application of Cost of Service in the Regulation of Natural Gas Companies Subsequent to 1954 and Prior to 1960.

In the period between this Court's *Phillips* decision and the Commission's opinion in the instant proceeding, the leading case concerning the Commission's application of rate making formulas was *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (D.C. Cir. 1955), cert. denied 352 U.S. 829 (1956). On review was a decision of the Commission which permitted Panhandle to recover in its rates the field price, or competitive price, for the gas produced by that pipeline company in its own fields, instead of a price based on the cost of producing the gas. *Panhandle Eastern Pipe Line Co.*, 13 FPC 53 (1954). In overruling the Commission the court held, at page 818, that conventional cost evidence must be used by the Commission at least as a basis of comparison. The court said:

> "It [cost of service] has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful—'just and reasonable'—rates under the Act. Unless it is continued to be used at least as *a point of departure*, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning." (Emphasis supplied).

After the *City of Detroit* case, the Commission itself also took this position. In *Union Oil Co. of California*, 16 FPC 100, 110 (1956), the Commission held that the *City of Detroit* case was controlling in independent producer rate cases.[21] In *Pan American Petroleum Corp.*, 19 FPC 519, 542-544 (1958), the Commission said that a producer could not show a rate to be just and reasonable absent evidence of cost of service. Commission demand for cost evidence was upheld in *Bel Oil Corp. v. Federal Power Commission*, 255 F.2d 548, 551-552 (5th Cir. 1958), cert. denied 358

21. Similar cases were: *Sun Oil Co.*, 17 FPC 174 (1956); *Orange Grove Oil & Gas Corp.*, 17 FPC 199 (1956); *H. F. Sears*, 18 FPC 214 (1957); *Delhi-Taylor Oil Corp.*, 18 FPC 375 (1957); *Sun Oil Co.*, 19 FPC 975 (1958).

U.S. 804 (1958); *Forest Oil Corp. v. Federal Power Commission*, 263 F.2d 622, 626 (5th Cir. 1959); *Episcopal Theological Seminary v. Federal Power Commission*, 269 F.2d 228, 236 (D.C. Cir. 1959), cert. denied 361 U.S. 895 (1959).

While during this period the Commission voiced its opposition to cost of service regulation of producers and supported legislation to free it from this method,[22] in those instances where it did act it followed that approach until the instant proceeding.

3. Application of Cost of Service in the Regulation of Natural Gas Companies Subsequent to 1960.

In the opinion in the instant proceeding the Commission made the following statement:

> "Experience of the Commission in this case, as well as in many other producer rate cases during the last five years, has shown, beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even workable, method of fixing the rates of independent producers of natural gas. The fact that in this case, we can, by making numerous arbitrary allocations and estimates, arrive at a calculated unit cost of gas does not prove to anyone's satisfaction, including ours, that we have solved the problem of fixing prices for natural gas sold by independent producers. We recognize that the use of this method for regulating utilities provides only some possible aid toward solving, but not the answer to, the problem of fixing producers' rates." (R. 256-257).

This, of course, was directly contrary to the view of the examiner who stated that "the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future rate proceedings * * *". (R. 65).

Because of this divergence of thought the position taken by the Commission and by its examiners subsequent to the present case is important. *Alfred C. Glassell, Jr.*, 25 FPC 1071 (1961), was the first independent producer rate case to follow the present case. The Commission said, at pages 1072-1073:

22. H.R. 6790, 85th Cong., 1st Sess. (1956).

"The examiner's reliance on cost of service evidence when he issued his decision on August 18, 1960, was correct. Since just and reasonable rates on an area basis have not yet been finally determined, for administrative reasons we have followed the practice of deciding on a cost of service basis proceedings which were ready for disposition on that basis prior to the announcement of our area price policy although we adhere to the view expressed in *Phillips* * * *. We will therefore make our decision on the same basis notwithstanding our comments in the *Phillips* opinion and Statement of General Policy No. 61-1."

Court review of the *Glassell* case was sought by the producer involved therein, *Alfred C. Glassell, Jr. v. Federal Power Commission*, United States Court of Appeals for the Fifth Circuit No. 19210. On February 8, 1962, the court remanded the case on the Commission's motion. In its motion the Commission stated:

"To some extent, at least, the Commission's experience has served to corroborate the view adopted in the present *Glassell* case that an abrupt abandonment of cost of service rate-making is not administratively feasible."

With one breath the Commission said cost of service is not sensible or workable; with the next breath it said it will use that very method in pending cases.

Commission examiners continue to rely on cost of service. In *Tidewater Oil Co.*, Docket No. G-13310, September 14, 1961, cost of service was applied and the examiner said: "[I]f the cost of service is constructed under the methods and techniques approved by the Commission * * * in the *Phillips* case, then the experience gained in the instant Tidewater proceeding would appear to demonstrate that the price results will be at a substantially lower level than field prices." (Mimeo. p. 5). In *Hunt Oil Co.*, Docket No. G-9065, October 2, 1961, and *Slade, Inc.*, Docket No. G-19986, November 1, 1961, examiners again used cost of service. The same was true in *Amerada Petroleum Corp.*, Docket No. G-9385, April 9, 1962. Here the examiner said:

> "Thus, insofar as independent producer cases in advance stages are concerned, the Commission not only by words but by deeds has receded from its view expressed in *Phillips* that the system-wide cost of service approach does not provide a workable basis for fixing rates for the future, at least until it concludes the area rate hearings which appears to be at a very considerable time in the future." (Mimeo. p. 12).

Finally, in a recent case, *Union Producing Co.*, Docket No. G-13811 June 26, 1962, the examiner adopted cost of service and pointed out:

> "[T]he Commission on numerous occasions has stated it did not intend to abandon the traditional cost-of-service method for determining rates for the future and especially in those cases which were in the hearing, or briefing, stage at the time the *Phillips* opinion was issued." (Mimeo. p. 15).

In the *Union Producing Co.* case, a consolidated Section 5(a) and Section 4(e) proceeding like the instant case, the examiner was able to provide sensible and workable solutions for problems involving depreciation and depletion, working capital, cost allocation, income taxes, and rate of return.

This history of producer rate cases subsequent to 1960 illustrates that cost of service is indeed a sensible and workable means of regulating producers. It is being utilized currently by the staff of the Commission as well as those producers who are parties to these various proceedings. There is no reason why the Commission should limit its use to cases pending prior to the opinion in the instant proceeding. The Commission should have used cost of service for the ultimate purpose of determining the justness and reasonableness of Phillips' rates, and should use it for this purpose in all such proceedings whether initiated before or after the issuance of the opinion here under review.

B. THE COMMISSION'S AND THE COURT'S OBJECTIONS TO COST OF SERVICE ARE UNSUPPORTED BY THE FACTS.

The court below, adopting the viewpoint of the Commission, listed several grounds for rejecting cost of service in producer rate

cases. The court asserted that such method "penalize[s] the efficient or fortunate and reward[s] the inefficient or unfortunate" (R. 414). Furthermore, "extremely difficult problems of allocating costs are involved." (R. 414). The Court referred to the royalty owners who may tend to lease to high cost producers only (R. 414-415). Finally, there is the "administrative burden of full rate cases for each of the thousands of independent producers." (R. 415). These grounds are without merit.

First, the court did not say how the so-called efficient or fortunate producer is penalized, what harm is inflicted upon him, how he suffers in contrast to the less efficient or unfortunate producer. The court's position assumes that there is some advantage to be gained by being inefficient and having bad luck. Under cost of service regulation both receive a fair return on investment and one is placed in no better position than the other. Actually, in our free enterprise system, other business factors, such as quality of service or competence of management, work to penalize the inept or unlucky and to favor the efficient or fortunate. Moreover, the court's position assumes that the producer with the high costs can sell his gas to pipelines at high rates in competition with the low cost producer, should such a competitive situation exist.

Second, the examiner's decision provides a sensible and workable formula for the allocation of costs between gas and oil. Neither the court nor the Commission questioned such formula. In pipeline rate cases the Commission often allocates with respect to the pipeline company's own production from joint product wells. Never has the Commission suggested that the cost of service method is unworkable in these situations because of the complexities of allocation.

Third, the rejection of cost of service in the interest of the royalty owners is unrealistic. The contention that these lease holders will lease to producers who can obtain high rates, thereby assuring greater royalties, is based on an ill-founded assumption that the lessor knows whether or not his lessee's operations will be efficient or fortunate, and knows the value of his land as a pro-

ducing field. To further assume that certain producers would intentionally increase costs or deliberately drill dry holes, for the benefit of royalty owners, is to sell short our free enterprise system as well as the natural gas industry.

Finally, the alleged administrative burden of producer rate cases can be met by an application of self-help and by the expedition of hearings and decisions. As already indicated, the delays incident to the instant proceeding—four years from the first hearing to the issuance of the opinion—and to the regulation of independent producers generally—twenty-four years from the enactment of the Act to the present—have been appalling. The mandate of Section 4(e) to "decide the same as speedily as possible" has not been followed. The blame for any administrative lag cannot be placed upon the cost of service method. One aid to overcoming any administrative burden would be to establish a uniform system of accounting and recording for producers. This the Commission has not done.

The foundation on which the rejection of cost of service is built is indeed very weak, if it exists at all. The cost of service computed by the Commission should have been applied to test Phillips' rates under the statutory standard. The reasons for not doing so in the instant proceeding, as well as for not applying it in future proceedings, are based on erroneous facts and unsupported assumptions.

C. THE NATURAL GAS ACT IS DESIGNED FOR COST OF SERVICE REGULATION.

The court below and the Commission, in abandoning cost of service, failed to consider the provisions of the Natural Gas Act as a single unit. When the Act is taken as a whole it becomes apparent that it was designed specifically by Congress to enable the Commission to regulate on a cost basis.

Section 6(a)[23] empowers the Commission to investigate and ascertain the actual legitimate cost of a natural gas company's

23. 52 Stat. 824 (1938), 15 U.S.C. § 717e(a) (1958). (Appendix A, p. 4).

property. Through Section 6(b)[24] the Commission may request an inventory of such property, a statement of its original cost, and information regarding the cost of additions to the property.

Section 8(a)[25] enables the Commission to prescribe the appropriate records to be kept and preserved, including records of cost-accounting procedures. Section 8(b)[26] provides that the Commission shall at all times have the right to inspect and examine all records of the natural gas company.

The Commission is given authority under Section 9[27] to require the carrying of proper and adequate depreciation and amortization accounts. Under Section 10[28] the Commission may demand annual and other periodic reports on such matters as "assets and liabilities, capitalization, investment and reduction thereof, gross receipts, interest due and paid, depreciation, amortization, and other reserves, cost of facilities, cost of maintenance and operation of facilities for the production, transportation or sale of natural gas, cost of renewal and replacement of such facilities, transportation, delivery, use, and sale of natural gas."

These provisions, together with Sections 4, 5 and 7, show a comprehensive plan of regulation based on cost and not a license for Commission action in an unlimited area.

All rates and charges made pursuant to the Natural Gas Act are dependent for lawfulness on an ultimate determination that said rates are just and reasonable. Just and reasonable rates must have their roots in a cost base. The Act has been so written to enable the Commission to obtain the financial and economic information necessary to use such method.

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24. 52 Stat. 824 (1938), 15 U.S.C. § 717e(b) (1958). (Appendix A, p. 4).

25. 52 Stat. 825 (1938), 15 U.S.C. § 717g(a) (1958). (Appendix A, p. 7).

26. 52 Stat. 825 (1938), 15 U.S.C. § 717g(b) (1958). (Appendix A, p. 8).

27. 52 Stat. 826 (1938), 15 U.S.C. § 717h (1958). (Appendix A, p. 8).

28. 52 Stat. 826 (1938), 15 U.S.C. § 717i (1958). (Appendix A, p. 9).

D. THE CONSTITUTIONAL RIGHTS OF PRODUCERS ARE PROTECTED BY COST OF SERVICE REGULATION.

California insists upon the continuation of regulation along cost lines because only this type of approach is in the public interest. Cost of service does not guarantee consumers the lowest possible rates; cost of service does assure rates which will protect consumers and which at the same time will assure the rights of the producers, as they must.

Congress has in Section 19(b) of the Natural Gas Act specifically cast upon the courts the duty to review rate orders of the Commission where any party is aggrieved. It is within the scope of the judicial power and part of judicial duty to restrain anything which, in the form of a regulation of rates, operates to deprive owners of their property without due process of law. *Chicago, M. & St. P. R. Co. v. Minnesota*, 134 U.S. 418, 455-456 (1890); *Federal Power Commission v. Natural Gas Pipe Line Co.*, 315 U.S. 575, 585, 609 (1942). A base of financial and economic information pertaining to the natural gas company is necessary to enable a court to determine whether or not a rate is confiscatory. The cost of service method provides this base.

California has had experience in regulation since 1911, together with regulatory experience gained in preceding years. It has been the experience of California that the only valid method of regulation is one which rests upon a foundation of cost. Absent costs, certainty is lost. As already indicated, California does not argue for cost of service because it assures consumers low prices. Consumers receive no such assurance. California favors cost of service because it is fair and equitable to industry and consumer alike. Regulation should not be based upon wispy concepts of value. Regulation must follow traditional lines and must be based upon certainties, such as, the company's debt money, equity capital, total wages, taxes, materials and supplies, and plant or rate base. Only through such course are consumers protected and producers guaranteed their rights.

E. A LOOK TO THE FUTURE.

It is beyond argument that the cost of service method is recognized as sensible and workable, and the lawfulness of such method has been determined by this and other courts. In short, it is an effective method of regulation. The gravity of the Commission's action in discarding cost of service must be measured against the realization that there is presently no known adequate or lawful substitute.

The Commission intends to explore the unknown for a theoretically ideal formula whereby producer rates and charges are precisely determined—but in the interim the only known and available weapon to be utilized for consumer protection has been laid down.

Assuming established commodity price levels for producer gas, should the Commission in the future have any doubt as to those prices, or to filings in conformity with such prices, what approach is the Commission going to use to test the lawfulness of the prices? If it is not the cost of service method which has been rejected, then it seems to California that the only remaining test would be some unknown, imprecise and arbitrary standard.

The abandonment of the cost approach is broad notice to all producers that any rate will be acceptable. An inability to prove an increase in his costs no longer dissuades a producer from filing for an increase, or consummating a sale at a high price. Area price levels are not a deterrent because a producer, under Section 4, has the right to file for increased rates at any time regardless of the pre-established levels. *H. L. Hunt v. Federal Power Commission*, United States Court of Appeals for the Fifth Circuit, No. 19065, July 19, 1962. A cost test then is the only safeguard for consumers.

Cost of service is as essential to future regulation as it was to past regulation. Its rejection in the instant proceeding brings uncertainty and confusion to the regulatory process.

V.

The Decision of the Court of Appeals and the Opinion of the Commission Fail to Provide Lawful Interim Regulation of Independent Producers.

"The difficult part of the case," said the court below, "* * * involves the rates for the period from 1959 until the new system—or a new system—is designed and established." (R. 421-422). This period includes all of Phillips' rates filed since January 1, 1959, whether they be increases under old contracts or initial prices in new contracts.

The difficulty lies in the type of regulation decided upon for this interim period which may last as long as fourteen years. (R. 422). The interim period extends from individual producer cost of service regulation, at one end, to the commodity pricing of gas on an area basis, at the other end. The form of regulation devised carries the Commission from the lawful, established and effective cost approach to the uncertain and untested area method. The vehicle offered to provide this transition is the Policy Statement.

A. THE POLICY STATEMENT IS FRAUGHT WITH LEGAL AND PRACTICAL INFIRMITIES WHICH MAKE IT AN UNLAWFUL AND INEFFECTIVE FORM OF REGULATION.

The court below approved the Commission's promulgation of the Policy Statement wherein the Commission established "maximum acceptable rates" above which it will suspend Section 4(e) rate increases and condition Section 7 initial price applications. (R. 344). Such levels, announced in conjunction with the instant proceeding (R. 325), are being used until new area rate procedures are developed, assuming they are developed. The court said:

> "[The Commission] has announced guideline rates which it deems to be on the basis of the internal data in its files on all operators in the several areas, fair rates for the product in those areas. *Such rates, thus determined, would seem to be just and reasonable rates for the consumers of the product.* And, similarly, they would seem to be just and reasonable charges for the producers to make." (R. 425). (Emphasis supplied).

What the court overlooked is that the rates contained in the Policy Statement were determined, and can be changed, without notice, hearing, or the taking of evidence. Moreover, the Commission itself does not consider the guideline rates to be necessarily just and reasonable rates:

> "These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights, or fix the ultimate justness and reasonableness of any rate level." (R. 346).

California agrees with the Commission insofar as it stated that the Policy Statement rates are not just and reasonable by the fact of their promulgation. Of course, California disagrees with the court's characterization of them as "just and reasonable rates for consumers."

The question is whether or not the Policy Statement deprives parties of substantive rights. California contends that it does. Congress designed Sections 4(e) and 5(a) for the purpose of determining lawful rates under the just and reasonable standard. By the Policy Statement the Commission reserves the right to approve rate increases and initial prices on the sole criterion that they are at or below pre-established levels. These levels are admittedly not just and reasonable determinations. How then can the Commission base its rate making function, and its obligation to protect consumers, on these levels? Moreover, how is the Commission able to shift to other parties the burden of challenging rates which are at or below the Policy Statement levels?

An example of Commission performance under Policy Statement regulation is the case of *F. A. Callery, Inc.*, Docket No. G-13993. On November 27, 1957, F. A. Callery, Inc. (Callery) tendered for filing a proposed increase to 10.5¢ per Mcf in a sales contract with El Paso. The rate was suspended and, after expiration of the suspension period, became effective subject to refund. On December 23, 1960, the Commission consolidated this docket with other dockets in *Area Rate Proceeding, et al.*, Docket Nos. AR 61-1, et al. On May 16, 1962, the Commission issued an order terminating

the *Callery* proceeding and discharging Callery from any obligation to make refunds. 27 Fed. Reg. 4845 (1962). The reason offered by the Commission for the termination and discharge was that Callery's increased rate was below the applicable 11¢ per Mcf ceiling established by the Policy Statement. At no time did California, an intervenor, have an opportunity to assert a position as to the justness and reasonableness of the rate. Never was there a hearing or the taking of evidence respecting the rate. California, to protect its rights, petitioned for rehearing, which petition was granted on July 10, 1962, and further proceedings are pending.

Another example is *Shell Oil Co.*, Docket No. G-9446. This is a general rate investigation, pursuant to Section 5(a), of a major independent producer. Hearings commenced in this proceeding on July 7, 1960, and in the course of the hearings, California presented in evidence a cost of service showing. On August 1, 1962, the Commission severed those dockets of special interest to California from the *Shell* proceeding and consolidated them with *Area Rate Proceeding, et al.*, Docket Nos. AR 61-1, et al. Now, as a consequence of this action, California may have to wait as long as fourteen years for a decision as to the justness and reasonableness of Shell's rates, just as it has been required to wait for a decision in the instant proceeding.

These, of course, are examples of particular significance to California. However, they serve to emphasize the great power the Commission has conferred upon itself through this interim form of regulation.

The area price levels established in the Policy Statement were promulgated without notice to anyone. This was a failure to comply with Sections 4(a)[29] and 4(b)[30] of the Administrative Procedure Act which provide that notice of proposed rule making be published in the Federal Register and that the agency afford interested parties the opportunity to submit their views in writing.

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29. 60 Stat. 238 (1946), 5 U.S.C. § 1003(a) (1958). (Appendix A, p. 11).

30. 60 Stat. 238 (1946), 5 U.S.C. § 1003(b) (1958). (Appendix A, p. 11).

While Section 4(a) excepts statements of general policy from the notice requirement, the area price levels cannot be classified merely as policy matters since they are designed to have immediate effect and impact on rate making and rate lawfulness. Furthermore, by labeling the document a policy statement, interested persons were denied the right to petition, under Section 4(d)[31] of the Administrative Procedure Act, for amendment or repeal.

The Policy Statement levels are also unlawful because they were established without hearing and taking of evidence. Consumers have not been allowed to argue that the area levels are too high or that a particular producer should not be allowed a rate at the fixed level. The consumers' only recourse is a Section 5(a) proceeding, such as was abandoned in the instant proceeding; yet this does not provide adequate protection because of the absence of a provision for refunding excessive rates. Moreover, the Commission appears to have abandoned new company-wide Section 5(a) hearings pending decision, if such is forthcoming, on the area rate scheme.

Section 5[32] of the Administrative Procedure Act provides that where a statute calls for an agency hearing, there must be notice and opportunity to be heard. The Commission's own Rules of Practice and Procedure are especially designed for hearings on rate matters. FPC Rules and Regulations, Secs. 1.13-1.26, 18 C.F.R. §§ 1.13-1.26. Accordingly, the Commission's insistence on going its own way, without hearings, in rate matters is unprecedented.

If it be lawful for the Commission to announce rates as it did without notice and without hearing, and certainly without any evidence, then it is lawful for it to modify such rates in the future in like manner. Consequently, the Commission, unless prevented by this Court, can announce on any day a new policy statement and a new level of rates which might double, or triple, present

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31. 60 Stat. 238 (1946), 5 U.S.C. § 1003(d) (1958). (Appendix A, p. 12).

32. 60 Stat. 238 (1946), 5 U.S.C. § 1004 (1958). (Appendix A, p. 12).

prices. And the Commission, having abandoned cost of service, can justify its action on its own terms.

B. THE POLICY STATEMENT IS INCONSISTENT WITH THE FORM OF REGULATION PROVIDED BY THE NATURAL GAS ACT.

California insists that the pattern of regulation provided by the Natural Gas Act is the only lawful form of regulation and, moreover, such pattern provides for effective results. The innovations which are the consequence of the instant proceeding are not only unlawful but also constitute illusory regulation.

Section 4(e) provides that when a producer files for a rate increase the Commission shall have authority to enter upon a hearing "at once" concerning the lawfulness of such rate. Pending such hearing the Commission may suspend the increase for as long as five months. If the rate becomes effective before a hearing is concluded, the Commission may require a bond to assure refunds, if any are later ordered. The burden of proof that the increased rate is just and reasonable is placed upon the producer, and the "Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible."

Policy Statement regulation operates quite differently. By announcing maximum acceptable rates for increases under existing contracts, and by making the suspension and hearing provisions apply to rate increases above the acceptable levels, the Commission, in effect, established a rate floor. Rates that otherwise would be below the Policy Statement "ceiling" are in reality drawn up to that level as a floor.

While the ideal of a master rate for each gas producing area of the nation carries a certain appeal coming from notions of stability and permanency, nonetheless such a condition of static rates cannot in truth be achieved through the commodity price method, because Congress has made plain its intention as to the right of natural gas companies to file for increased rates under Section 4 of the Act. In *H. L. Hunt v. Federal Power Commission*,

United States Court of Appeals for the Fifth Circuit, No. 19065, July 19, 1962, the court said:

> "But we view the [Commission's] express prohibitions of § 4 increases as beyond the pale of administrative discretion. We do not think that under the guise of a condition of a temporary authorization, the Commission can forbid what Congress has expressly allowed to a natural gas producer." (Mimeo. p. 12)

In brief, producers will continue to file for rate increases as they have done in the past. All the Policy Statement accomplishes, then, is the raising of general area prices to a higher plateau.

Since the Natural Gas Act permits rates to be increased so easily, there must be some solid, meaningful measuring standard by which increased rates can be measured and quickly rejected, if found to be too high. If it be the objective of the Commission to curtail the upward increase in the price of natural gas, such increase, if improper, must be measured against a standard fixed under accepted criteria. Increases cannot be accepted, or rejected, by reference to other prices, so unstable and arbitrary as those set out in the Policy Statement. If it be the objective of the Commission to abate increasing producer prices, it can do so by comparing increases with rates and charges which were determined upon a basis of costs, for such rates will furnish an acceptable, reliable yardstick by which the Commission can lawfully evaluate rate increases.

Turning to the initial price levels in the Policy Statement, it is clear that, as regulatory controls, they are meaningless. Under the Policy Statement the Commission will issue a certificate of public convenience and necessity on the condition that the producer reduce the initial price to the applicable level. However, there is no way of preventing the producer from filing for a rate increase under the same contract on the next day, or the next minute. *H. L. Hunt v. Federal Power Commission*, United States Court of Appeals for the Fifth Circuit, No. 19065, July 19, 1962.

The plight of the consumers is especially aggravated by this situation respecting certificate proceedings under Section 7 of the

Act. All new projects, all new contracts, and all new sales by producers in interstate commerce are made under the authority of this section. Moreover, the continual growth of the natural gas industry means that there will be more and more applications for certificates. Consequently, consumers have a real interest in prices arranged by private contract and submitted to the Commission for approval. These initial prices are determined, and influenced, by the price levels set forth in the Policy Statement, which have never been scrutinized under the just and reasonable standard. (R. 346). Initial prices, instead of being held in line by the Commission, are brought up to the line drawn by the Policy Statement.

In the event the initial price or the established price levels are ultimately determined to be excessive in a Section 5 proceeding, such determination will be meaningless to consumers, who paid the untested prices, for the basic reason that there is no mechanism whereby the intervening overcharges may be recovered. This Court has already commented on this situation: "This long delay, without the protection of refund, as is possible in a § 4 proceeding, would provide a windfall for the natural gas company with a consequent squall for the consumers." *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 390 (1959).

Under Policy Statement regulation, Section 5(a) rate proceedings, which permit no retroactive downward adjustments in rates through refunds, provide the only procedure whereby consumers, through state commissions, can demand that a hearing be held to determine whether initial prices in new contracts are just and reasonable and whether the Policy Statement levels are just and reasonable. A state commission may initiate such proceedings upon complaint. This Court, however, has commented upon "the delay incident to a determination in § 5 proceedings" referring to such as "nigh interminable." *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378, 389 (1959).

Furthermore, a complaint, in reality, is a measure seldom used and, insofar as rates are concerned, not the statutory device intended by Congress for the protection of consumers. This Court

need only contemplate the difficulties facing the complainant who undertakes the massive effort to persuade the Commission that a producer's rates are unlawful. Unaided by the specialized staff of the Federal Power Commission and without the necessary familiarity with the Commission's records, maintained only in Washington, D. C., a Section 5 complainant is obviously in a difficult, if not impossible, position to bear the burden of a proper investigation. Thus, a Section 5 proceeding instituted by complaint is more of a notion than a reality.

California believes that there is no justification for this new form of regulation by Policy Statement fiat. Cost of service regulation under the Natural Gas Act is a lawful and effective way to regulate independent producers. It must be followed.

Six years after being ordered to commence regulation of producers, the Commission, upon the threshold of a lawful, established and effective manner of doing so, turns its back upon the process and sets forth into new, uncharted fields and courses. Judging by the Policy Statement, the answers it seeks, even if ultimately discerned, are certain to be fraught with legal and practical infirmities. Most importantly, the development of a new regulatory scheme apparently will require years of searching, exploration and experimentation which, when added to the time already expended by the Commission (now to be abruptly jetisoned), may produce at best a dubious method of regulation some fourteen years from now.

The opinion of the Commission and the decision of the court below in the instant proceeding have brought uncertainty and confusion to independent producer regulation by suspending statutory regulation while new theories are explored. Regulation has been replaced by experimentation. Consumer interests have been dispatched to a regulatory limbo to await a judgment that may never come.

VI.

The Spiral Escalation Clauses in Phillips' Contracts Are Derogatory of the Public Interest and Void in This Regulatory Setting.

Spiral escalation clauses can be explained by a description of their operation. These clauses permit increases in the contract price received by a producer from a pipeline company when there is an increase in a price index followed by an increase in the resale rates of the pipeline. When both these conditions are met, the contract price is increased in proportion to the increase in the resale rates. The Phillips-El Paso contracts contain typical spiral escalation clauses. These agreements provide that when the Bureau of Labor Statistics' Annual Index of Wholesale Prices of All Commodities increases more than a prescribed number of points and a general increase in El Paso's rates is put into effect, then Phillips' rates will be increased in proportion to the increase in El Paso's rates. (R. 201-203). (The spiral escalation clauses involved in this proceeding are set out in Appendix B to this Brief).

The spiral escalation clause, once it is activated, or triggered, results in an indefinite upward movement of the contract price. Under such a clause, rate increases obtained by the pipeline company cause an upward adjustment in the purchase contract price which, in turn, necessitates another rate increase for the pipeline company, leading to a new adjustment in the purchase contract price, and so on. The provision derives its distinctive name from this upward price spiraling effect.

Furthermore, Phillips has agreed to spiral escalation clauses in contracts with its suppliers. (R. 111-112). Consequently, when a pipeline company's resale rates are increased, thereby triggering Phillips into obtaining a Section 4(e) rate increase, Phillips is compelled to pay a correspondingly higher rate to its suppliers when they, in turn, increase their rates based on the spiral escalation clauses in their contracts with Phillips. The next step is only too apparent. Phillips, its gas purchase costs having increased, may demand higher prices for the gas it sells.

The unfortunate consequence of this multiple spiraling is the economic impact on the natural gas consumer. First, these in-

creases have no bearing on economic factors, such as the cost of producing gas, but are based on fortuitous events. Second, in California's instance, the price of natural gas to the California consumer is largely dependent upon the rates set by the Commission for the sale of gas by El Paso for resale in California. These rates, in turn, are dependent to a great extent upon the cost to El Paso of natural gas purchased by it from Phillips. Therefore, rate increases, resulting from the operation of spiral escalation clauses, are passed on to the ultimate consumer. It is the consumer's dollar, then, which permits Phillips the luxury of these devices.

Consumers of natural gas are caught in a maelstrom by such producer price mechanisms. As population increases more gas is required by the pipeline companies to render adequate service. If the pipeline companies buy new gas at higher prices, and obtain rate increases because of these higher costs, ironically, the escalator triggers are sprung which increase the price of all the gas they buy.

California insists that the nation is entitled to regulation which prohibits these contrived price adjustments.

In the instant proceeding, Section 4(e) Docket Nos. G-11217, G-10883, and G-10793 are rate increase filings based on the triggering of spiral escalation clauses. The Commission left open Docket Nos. G-11217 and G-10883 only for the resolution of the extent of the increase and for "no other matter." (R. 329). In the third docket, G-10793, the rate increase was allowed to become effective. Consequently, in each instance, the Commission gave legal effect to the clauses.

The Commission made it clear that one of the major issues in this proceeding was whether spiral escalation clauses are "so ambiguous in language and so inflationary in effect as to contravene the public interest and conflict with the regulatory powers of the Commission or are otherwise unlawful." (R. 32). Nevertheless, in its opinion, the Commission said:

> "While we do not approve of such clauses in principle, there is not sufficient basis on this record to hold them so derogatory of the public interest as to be void as a matter of law." (R. 327).

The Commission's failure to declare spiral escalation clauses void is one of the startling aspects of the opinion. It is especially surprising upon review of the Commission's position in *Michigan-Wisconsin Pipe Line Co.*, 13 FPC 326, 348-349 (1954). In that decision the Commission said:

> "Any provision in a gas purchase contract which provides for an increase based on the rates to be charged by the purchaser for the sale of such natural gas in interstate commerce for resale is *inconsistent with the standards of the Natural Gas Act and contrary to the public interest as a matter of law* * * *." (Emphasis supplied).

The strongest denunciation of spiral escalation clauses has been made by the Commission itself in *The Pure Oil Co.*, 25 FPC 383 (1961), affirmed *The Pure Oil Co., v. Federal Power Commission*, 299 F.2d 370 (1962). In that proceeding the Commission was considering whether indefinite escalation clauses were void or voidable. California believes it is rewarding to quote from that decision at length:

> "Considering all the circumstances, we are of the opinion that the two-party favored nation clauses in Pure's contracts with El Paso, and indefinite escalation clauses generally, are contrary to the public interest. From the beginning of Commission regulation of independent producers under the *Phillips* decision in 1954, the undesirable and injurious aspects of such escalation provisions generally have been forcibly impressed on us and proceedings were early instituted looking to the elimination of such provisions. And although the record in this case was made with special reference to Pure's two-party provisions, by reasonable implication it confirms our conclusion based upon our experience with other types of indefinite escalation provisions, that such provisions generally are contrary to the public interest. * * * (25 FPC at 388).
>
> "The record establishes that Pure's favored nation clauses are contrary to the public interest in a number of ways. First, they are, in the context of Commission regulation of producers under the Act, by their nature and in their effects inherently unreasonable. * * * In our view, such an artificial

ground for a proposed increase, operating in such a mechanical and arbitrary manner, and lacking any substantial relationship to the factors which bear on the value of gas or on a determination of a reasonable level of rates for it, does not constitute a proper basis for filing proposed increased rates or a sufficient justification for our giving effect to such a filing. * * * (25 FPC at 389).

"Assuming that indefinite escalation clauses in producer contracts had some justification years ago, when a lack of purchaser outlets and lack of consumer demand forced prices to abnormally low levels, this justification no longer exists today, when purchasers of gas are numerous, consumer demand is strong, and buyers are competing eagerly for available supplies of gas. In our judgment, in the light of continuing increases in the price of gas in recent years and the present high level of prices, escalation clauses such as Pure's have by now outlived whatever economic function they may have had * * *." (25 FPC at 391).

In conjunction with the issuance of the *Pure* decision, the Commission issued FPC Order No. 232, 26 Fed. Reg. 1983 (1961), and FPC Order No. 232A, 25 FPC 609 (1961), 26 Fed. Reg. 2850 (1961), wherein the Commission found that spiral escalation clauses were "undesirable, unnecessary, and incompatible with the public interest for the due and proper development of natural gas service by natural gas companies," and announced that contracts containing them, executed after April 3, 1961, would be rejected. Later, by FPC Order No. 242, 27 Fed. Reg. 1356 (1962), the Commission announced that contracts filed after April 2, 1962, would be unacceptable if they contained spiral escalation clauses. In this order the Commission said: "[I]n protecting the public against waves of increases which have no defensible basis, we also serve the need—which we believe we should take into account—of making the tasks of regulation more manageable."

In a recent case, a Commission examiner refused to allow rate increases based on indefinite escalation clauses, even though such clauses had been in contracts made prior to the above series of

orders. He said: "[The] clauses in Respondents' contracts are no longer consistent with the public interest, and therefore they must not be encouraged in a regulatory setting." *Shell Oil Co.*, Docket No. RI 61-515, July 24, 1962.

California's position is this: If spiral escalation clauses are contrary to the public interest they have always been so, regardless of the dates when the contracts were executed or filed.

Natural gas purchase contracts are long-term contracts, the usual duration being twenty years. Spiral escalation clauses in contracts executed prior to April 3, 1961, or filed prior to April 2, 1962, may well plague consumers for many years to come. They have no place, at any time, in the business practices of an industry which is affected with a public interest. Moreover, the Commission has no right, and certainly no discretion, to perpetuate the existence of something which is unlawful.

This proceeding presents the issue of whether or not spiral escalation clauses are valid on public policy grounds. It is a fundamental principle of law that courts will not lend their aid to uphold contracts which are inconsistent with public policy. *Marshall v. Baltimore & O. R. Co.*, 57 U.S. (16 How.) 314, 334 (1853); *Gibbs v. Consolidated Gas Co.*, 130 U.S. 396, 405-406 (1889); *Hazelton v. Sheckells*, 202 U.S. 71, 79 (1905); *Crocker v. United States*, 240 U.S. 74, 78-82 (1915); *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520, 564-566 (1961).

In *South Carolina Generating Co.*, 19 FPC 855, 860-862 (1958), the Commission found that an automatic escalation clause in an electric energy purchase contract was unjust and unreasonable. This finding was sustained on appeal. *South Carolina Generating Co., v. Federal Power Commission*, 261 F.2d 915, 917 (4th Cir. 1958). A similar finding should have been made in the instant proceeding.

It is significant that spiral escalation clauses were included in Phillips' contracts before Phillips was held to be within the Commission's jurisdiction. Their origin at a time when the regulation of producers was unknown makes such provisions all the more questionable. That these clauses are the result of private

agreement does not entitle them to any special consideration in a regulatory setting. As one court has stated: "That private contract rights must yield to the public welfare, where the latter is appropriately declared and defined and the two conflict, has often been decided by this Court." *Mississippi River Fuel Corp. v. Federal Power Commission*, 121 F.2d 159, 163 (8th Cir. 1941).

The court below recognized the unlawful character of these devices, but erred in holding the question of their legality not ripe for review. The court said:

> "Wisconsin and California contend that the Commission should now declare these escalation clauses to be illegal and void as against public policy. As a matter of fact the Commission has declared these clauses to be against the public interest and that they should be held inoperative. But, the Commission says, insofar as these cases of Phillips are concerned, action of the sort demanded by Wisconsin and California is premature. Action on these clauses, it says, should await action on the pending cases which in orderly processes present the problem for decision. We agree with the Commission." (R. 426-427).

The court neglected to note that Dockets Nos. G-11217 and G-10883 were left open only to await the outcome of the pipeline companies' rate proceedings so that the Commission might determine the amounts of price escalation Phillips would receive under the clauses. The escalation clause in Docket No. G-10793, being unaffected by pending pipeline company litigation, was approved outright. In each instance, Commission approval of the spiral escalation clauses themselves presents the issue for review. See *Atlantic Seaboard Corp. v. Federal Power Commission*, 204 F.2d 568, 572 (4th Cir. 1953).

Spiral escalation clauses, the cause of consumer price increases which are unrelated to the factors involved in procuring gas, and the product of contract negotiations which were unrestrained by any regulatory influence, permit the exploitation of consumers in contravention of the primary purpose of the Natural Gas Act. Such contract provisions are derogatory of the public interest and void in this regulatory setting.

VII.

The National Importance and Significance of Independent Producer Regulation.

Independent producers, such as Phillips, sell natural gas to pipeline companies, such as El Paso, at wellheads, at field gathering points, or at outlets of processing plants. The prices established at these points of sale are crucial in the determination of the prices set by the pipeline companies in their sales to the distributing companies, and the prices charged by the latter to the ultimate consumers of the nation.

Absent producer regulation, the Natural Gas Act would be only a makeshift barricade against a surging river without any attempt to control the river itself. It should now be apparent to all that the regulation of pipeline prices was less than whole when the prices paid by the pipelines to the producers were unregulated.

Effective regulation of independent producers is possible under the Act as written by Congress. But proceedings must be handled with zeal and dispatch, and not with indecision, indifference and delay.

The need for effective producer regulation is emphasized by the rising cost of producer gas.

In 1950 producer sales, nation-wide, amounted to $409,000,000. By 1960, as the amount of gas sold doubled, the dollar cost of producers' gas increased over four times to $1,790,000,000.[33] When these staggering figures are translated into the cost to the ultimate gas consumers, they are further increased because of the expenses of and the return to pipelines and local distributing companies.

Time is crucial in this proceeding. Accordingly, the proceeding may best be disposed of, in the national interest, by following the position of Judge Fahy in his dissent:

> "These cases need not be treated as if they were ventures initiated in search of an ideal method of regulating the rates of independent gas producers. Having in mind the history of these proceedings, and the primary congressional purpose

33. Source: Bureau of Mines Mineral Yearbook, U.S. Dept. of Interior, Vols. 1951 and 1960.

> of consumer protection, it seems to me that decisions on the present record, supplemented as may be found to be reasonably necessary, would be far more likely to approximate fulfillment of the purposes of the Act than are the termination order and the resulting situation." (R. 429).

The consumers, at the extreme end of the pipeline, can have no effective regulatory protection unless the rates at which the producers sell their gas to the pipelines are adequately regulated. This Court, in referring to the sale of gas in the field to a pipeline company, has said:

> "Unreasonable charges extracted at this stage of the interstate movement become perpetuated in large part in fixed items of costs which must be covered by rates charged subsequent purchasers of gas, including the ultimate consumer." *Interstate Natural Gas Co. v. Federal Power Commission*, 331 U.S. 682, 693 (1947).

Effective regulation requires that there be no gap in the regulatory scheme at either the production or the consumer end of the pipeline.

CONCLUSION

California has a vital interest in all matters concerned with the regulation of natural gas companies. This interest arises from the fact that California gas distributing utilities, serving a population in excess of fifteen million people, are dependent upon out-of-state supplies for over three-quarters of the natural gas consumed within the State.

The Commission's action in terminating this proceeding, without a determination on the issue of the lawfulness of Phillips' rates, deprived California of its right to a decision and the public of its interest in the enforcement of the Natural Gas Act in accordance with the dictates of Congress.

By way of relief, California requests:

1. That the decision of the Court of Appeals be reversed, and the Commission's order of termination be set aside.

2. That the proceeding be remanded to the Commission with directions to take whatever action is necessary to correct the errors specified herein.

3. Such other relief as to this Court may seem meet and proper.

Respectfully submitted,

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Dated: August 22, 1962.

(Appendices Follow)

Appendix A

RELEVANT PARTS OF STATUTES INVOLVED

The relevant parts of the Natural Gas Act (Act of June 21, 1938, c. 556, 52 Stat. 821-833 (1938), 15 U.S.C. §§ 717-717w (1958)) involved in this proceeding are as follows:

SEC. 1. (a) As disclosed in reports of the Federal Trade Commission made pursuant to Senate Resolution 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest.

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any trans-

poration or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper

in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however*, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such

natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas.

SEC. 6. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.

(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction.

SEC. 7. (a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided*, That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell

natural gas when to do so would impair its ability to render adequate service to its customers.

(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however*, That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on the effective date of this amendatory Act, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after the effective date of this amendatory Act. Pending the determination of any such application, the continuance of such operation shall be lawful.

In all other cases the Commission shall set the matter for hearing and shall give such reasonable notice of the hearing thereon to all interested persons as in its judgment may be necessary under rules and regulations to be prescribed by the Commission, and the application shall be decided in accordance with the pro-

cedure provided in subsection (e) of this section and such certificate shall be issued or denied accordingly: *Provided, however,* That the Commission may issue a temporary certificate in cases of emergency, to assure maintenance of adequate service or to serve particular customers, without notice or hearing, pending the determination of an application for a certificate, and may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest.

(d) Application for certificate shall be made in writing to the Commission, be verified under oath, and shall be in such form, contain such information, and notice thereof shall be served upon such interested parties and in such manner as the Commission shall, by regulation, require.

(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of the Act and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

(f) The Commission, after a hearing had upon its own motion or upon application, may determine the service area to which each authorization under this section is to be limited. Within such service area as determined by the Commission a natural-gas company may enlarge or extend its facilities for the purpose of supplying increased market demands in such service area without further authorization.

(g) Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company.

(h) When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate, and maintain a pipe line or pipe lines for the transportation of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper operation of such pipe line or pipe lines, it may acquire the same by the exercise of the right of eminent domain in the district court of the United States for the district in which such property may be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: *Provided*, That the United States district courts shall only have jurisdiction of cases when the amount claimed by the owner of the property to be condemned exceeds $3,000.

SEC. 8. (a) Every natural-gas company shall make, keep, and preserve for such periods, such accounts, records of cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may by rules and regulations prescribe as necessary or appropriate for purposes of the administration of this act: *Provided, however*, That nothing in this act shall relieve any such natural-gas company from keeping any accounts, memoranda, or records which such natural-gas company may be required to keep by or under authority of the laws of any State. The Commission may prescribe a system of accounts to be kept by such natural-gas companies, and may classify such natural-gas companies and prescribe a system of accounts for each class. The Commission, after notice and opportunity for hearing, may de-

termine by order the accounts in which particular outlays or receipts shall be entered, charged, or credited. The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry, and the Commission may suspend a charge or credit pending submission of satisfactory proof in support thereof.

(b) The Commission shall at all times have access to and the right to inspect and examine all accounts, records, and memoranda of natural-gas companies; and it shall be the duty of such natural-gas companies to furnish to the Commission, within such reasonable time as the Commission may order, any information with respect thereto which the Commission may by order require, including copies of maps, contracts, reports of engineers, and other data, records, and papers, and to grant to all agents of the Commission free access to its property and its accounts, records, and memoranda when requested so to do. No member, officer, or employee of the Commission shall divulge any fact or information which may come to his knowledge during the course of examination of books, records, data, or accounts, except insofar as he may be directed by the Commission or by a court.

SEC. 9. (a) The Commission may, after hearing, require natural-gas companies to carry proper and adequate depreciation and amortization accounts in accordance with such rules, regulations, and forms of account as the Commission may prescribe. The Commission may from time to time ascertain and determine, and by order fix, the proper and adequate rates of depreciation and amortization of the several classes of property of each natural-gas company used or useful in the production, transportation, or sale of natural gas. Each natural-gas company shall conform its depreciation and amortization accounts to the rates so ascertained, determined, and fixed. No natural-gas company subject to the jurisdiction of the Commission shall charge to operating expenses any depreciation or amortization charges on classes of property other than those prescribed by the Commission, or charge with respect to any class of property a percentage of depreciation or amortization other than that prescribed therefor by the Com-

mission. No such natural-gas company shall in any case include in any form under its operating or other expenses any depreciation, amortization, or other charge or expenditure included elsewhere as a depreciation or amortization charge or otherwise under its operating or other expenses. Nothing in this section shall limit the power of a State commission to determine in the exercise of its jurisdiction, with respect to any natural-gas company, the percentage rates of depreciation or amortization to be allowed, as to any class of property of such natural-gas company, or the composite depreciation or amortization rate, for the purpose of determining rates or charges.

(b) The Commission, before prescribing any rules or requirements as to accounts, records, or memoranda, or as to depreciation or amortization rates, shall notify each State commission having jurisdiction with respect to any natural-gas company involved and shall give reasonable opportunity to each such commission to present its views and shall receive and consider such views and recommendations.

SEC. 10. (a) Every natural-gas company shall file with the Commission such annual and other periodic or special reports as the Commission may by rules and regulations or order prescribe as necessary or appropriate to assist the Commission in the proper administration of this act. The Commission may prescribe the manner and form in which such reports shall be made, and require from such natural-gas companies specific answers to all questions upon which the Commission may need information. The Commission may require that such reports shall include, among other things, full information as to assets and liabilities, capitalization, investment and reduction thereof, gross receipts, interest due and paid, depreciation, amortization, and other reserves, cost of facilities, cost of maintenance and operation of facilities for the production, transportation, or sale of natural gas, cost of renewal and replacement of such facilities, transportation, delivery, use, and sale of natural gas. The Commission may require any such natural-gas company to make adequate provision

for currently determining such costs and other facts. Such reports shall be made under oath unless the Commission otherwise specifies.

(b) It shall be unlawful for any natural gas company willfully to hinder, delay, or obstruct the making, filing, or keeping of any information, document, report, memorandum, record, or account required to be made, filed, or kept under this act or any rule, regulation, or order thereunder.

SEC. 19. (b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission

and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in [former] sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254).

The Relevant Parts of the Administrative Procedure Act (Act of June 11, 1946, c. 324, 60 Stat. 242-244 (1946), 5 U.S.C. §§ 1001-1011 (1958)), involved in this proceeding are:

Sec. 4(a). General notice of proposed rule making shall be published in the Federal Register (unless all persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law) and shall include (1) a statement of the time, place, and nature of public rule making proceedings; (2) reference to the authority under which the rule is proposed; and (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved. Except where notice or hearing is required by statute, this subsection shall not apply to interpretative rules, general statements of policy, rules of agency organization, procedure, or practice, or in any situation in which the agency for good cause finds (and incorporates the finding and a brief statement of the reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

Sec. 4(b). After notice required by this section, the agency shall afford interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity to present the same orally in

any manner; and, after consideration of all relevant matter presented, the agency shall incorporate in any rules adopted a concise general statement of their basis and purpose. Where rules are required by statute to be made on the record after opportunity for an agency hearing, the requirements of sections 7 and 8 shall apply in place of the provisions of this subsection.

Sec. 4(d). Every agency shall accord any interested person the right to petition for the issuance, amendment, or repeal of a rule.

Sec. 5. In every case of adjudication required by statute to be determined on the record after opportunity for an agency hearing, except to the extent that there is involved (1) any matter subject to a subsequent trial of the law and the facts de novo in any court; (2) the selection or tenure of an officer or employee of the United States other than examiners appointed pursuant to section 1010 of this title; (3) proceedings in which decisions rest solely on inspections, tests, or elections; (4) the conduct of military, naval, or foreign affairs functions; (5) cases in which an agency is acting as an agent for a court; and (6) the certification of employee representatives.

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(b) The agency shall afford all interested parties opportunity for (1) the submission and consideration of facts, arguments, offers of settlement, or proposals of adjustment where time, the nature of the proceeding, and the public interest permit, and (2) to the extent that the parties are unable so to determine any controversy by consent, hearing, and decision upon notice and in conformity with sections 7 and 8 of this title.

Sec. 8(b). Prior to each recommended, initial, or tentative decision, or decision upon agency review of the decision of subordinate officers the parties shall be afforded a reasonable opportunity to submit for the consideration of the officers participating in such decisions (1) proposed findings and conclusions, or (2) exceptions to the decisions or recommended decisions of subordinate officers or to tentative agency decisions, and (3) sup-

porting reasons for such exceptions or proposed findings or conclusions. The record shall show the ruling upon each such finding, conclusion, or exception presented. All decisions (including initial, recommended, or tentative decisions) shall become part of the record and include a statement of (1) findings and conclusions, as well as the reasons or basis therefor, upon all the material issues of fact, law, or discretion presented on the record; and (2) the appropriate rule, order, sanction, relief, or denial thereof.

Appendix B

SPIRAL ESCALATION CLAUSES CONTAINED IN CONTRACTS OF PHILLIPS PETROLEUM COMPANY

The following is the spiral escalation clause found in the contract agreement between Phillips and El Paso Natural Gas Company, dated January 1, 1953, FPC Rate Schedule No. 7:

In order to protect the parties hereto from too great burden under the price provisions of this agreement in the event of abnormal inflation or deflation of prices of commodities generally, it is agreed that in the event of the happening of the contingencies hereinafter mentioned, an adjustment of the prices to be paid by El Paso to Phillips for gas hereunder shall be made as herein provided. Using as a standard the Federal Bureau of Labor Statistics' Annual Index of Wholesale Prices of All Commodities for any calendar year, based upon or adjusted to 1947-1949 prices as one hundred (100) and defining the word "point" as used herein to mean one percent (1%) of the 1947-1949 prices, it is agreed that no adjustment shall be made unless and until (1) the Annual Index shall be more than nineteen point naught six (19.06) points above the level seventy-six point nine (76.9) and El Paso shall have had an increase in resale rates, or (2) the Annual Index shall be more than nineteen point naught six (19.06) points below the level seventy-six point nine (76.9) and El Paso shall have had a decrease in resale rates. When revised rates shall become effective during any adjustment period, the price for gas delivered hereunder shall be adjusted to a price which bears the same ratio to the price provided in Section 1 of this Article which the revised resale rates bear to the resale rates in effect immediately prior to revision. The ratio referred to above shall be determined by applying the revised resale rates and the resale rates in effect immediately prior to revision respectively to the total volumes of gas sold by El Paso for resale during the twelve (12) calendar months next preceding said determination in the same manner as if such rates

respectively had been in effect. Further proportionate adjustments in the prices hereunder shall be made in the same manner whenever a further increase or decrease in the rates of El Paso shall become effective during any adjustment period; provided, that whenever the Annual Index shall be not more than nineteen point naught six (19.06) points above or below seventy-six point nine (76.9), the prices provided in Section 1 of this Article shall again be in effect. Whenever the Annual Index shall be more than nineteen point naught six (19.06) points above seventy-six point nine (76.9), El Paso shall diligently pursue all rights and remedies to which it is entitled in a good faith endeavor to bring about, and procure the approval of, an increase or succesive increases, as the case may be, in its rates to bring its rates up to the inflated price level. El Paso shall notify Phillips in writing within ten (10) days after receipt by El Paso of any general increase or decrease during any adjustment period in rates for gas sold by it for resale. The term "adjustment period" as used in this Section means the period beginning on the first day of the calendar month following the publication of the Annual Index showing such Index to be more than nineteen point naught six (19.06) points above or below seventy-six point nine (76.9) and ending on the first day of the calendar month following the publication of the Annual Index showing such Index to be less than nineteen point naught six (19.06) points above or below seventy-six point nine (76.9). For the purpose of applying the provisions of this Section, the price for gas delivered hereunder as provided in Section 1 of this Article shall be deemed to be the price provided in said Section 1, exclusive of the provisions relating to the weighted average price of gas at gasoline plants in the Permian Basin Area, and exclusive of the provisions of this Article relating to higher prices paid to others. If, for any calendar year an Annual Index is not published on or before April 1 of the following year, the Annual Index shall be deemed to be the arithmetic average of the monthly indices for the twelve (12) months of such calendar year and shall be deemed to have been published in March.

It is understood that the figure seventy-six point nine (76.9) used in this Section 4 refers to a certain level of the Wholesale Price Index Number for "all commodities" as heretofore determined by the Bureau of Labor Statistics of the United States Department of Labor based upon the 1947-1949 level of prices as one hundred (100). If the said Bureau (or a successor governmental agency) shall discontinue the publication of said Index for "all commodities" based on such 1947-1949 level, and shall adopt as a base price a level other than that of 1947-1949, the said figure seventy-six point nine (76.9) shall be adjusted accordingly. In the event publication of the Wholesale Price Index for "all commodities" shall be discontinued, the parties shall mutually agree upon the substitution of some other means of establishing an index number.

The following is the spiral escalation clause found in the contract agreement between Phillips and Panhandle Eastern Pipe Line Company, dated April 5, 1943, FPC Gas Rate Schedule No. 5:

In order to protect the parties hereto from too great a burden under the provisions of this contract in the event of abnormal inflation or deflation of prices of commodities generally, it is agreed that in the event of the contingencies hereinafter mentioned, an adjustment of the prices to be paid by Panhandle Eastern to Phillips for gas hereunder shall be made as herein provided. Using as a standard the Federal Bureau of Labor's Statistical Annual Index of Wholesale Prices of All Commodities, based upon 1947-1949 prices as 100% and defining the word 'point' as used herein to mean 1% of the 1947-1949 prices, it is agreed that no adjustment shall be made unless and until the said Annual Index shall be more than nineteen point naught six (19.06) above or below sixty-five point nine (65.9) and unless and until Panhandle shall have had a general increase or decrease in rates for gas from its pipe line system. However, if, when the said Annual Index is more than nineteen point naught six (19.06) above sixty-five point nine (65.9) the Federal Power Commission or other body or court having jurisdiction, shall grant to Pan-

handle Eastern a general increase in its rates for gas sold from its pipe line, it shall be conclusively presumed that such increase is due to inflation and the prices for gas hereunder shall be increased in proportion to such increase in Panhandle Eastern's rates; and if, when the said Annual Index is more than nineteen point naught six (19.06) below sixty-five point nine (65.9), said commission, or other body or court, shall require a general decrease in Panhandle Eastern's rates for gas sold from its pipe line system, it shall be conclusively presumed that such decrease is due to deflation and the prices for gas hereunder shall be reduced in proportion to such decrease in Panhandle Eastern's rates. Further proportionate adjustments in the prices hereunder shall be made in the same manner whenever a general increase or decrease in Panhandle Eastern's rates shall be put into effect; provided, that whenever the said Annual Index shall be not more than nineteen point naught six (19.06) above or below sixty-five point nine (65.9), the prices hereinabove specified shall again be in effect without adjustment.

The following is the spiral escalation clause found in the contract agreement between Phillips and Michigan-Wisconsin Pipe Line Company, dated December 11, 1945, FPC Gas Rate Schedule No. 4:

In order to protect Seller from too great burden under the price provisions of this contract in the event of abnormal inflation of prices of commodities generally, it is agreed that in the event of the happening of the contingencies hereinafter mentioned, an adjustment of the prices to be paid by Buyer to Seller for gas hereunder shall be made as herein provided. Using as a standard the Federal Bureau of Labor Statistics' Annual Index of Wholesale Prices of All Commodities for any calendar year, based upon or adjusted to 1926 prices as 100 and defining the word "point" for the purpose hereof to mean one percent of the 1926 prices, it is agreed that no adjustment shall be made unless and until (1) the Annual Index shall be more than thirty (30) points above the level (104.0) indicated by the Annual Index on December 11, 1945, and (2) Buyer shall have effective rates above 25¢ per Mcf for

gas sold by it for resale. If rates above said 25¢ per Mcf shall be effective during any adjustment period, the price of gas delivered hereunder shall be adjusted to a price which bears the same ratio to the price provided in Section 1 of this Article VIII as the effective rates bear to 25¢ per Mcf. Further proportionate adjustments in the prices hereunder shall be made in the same manner whenever a further revision in the rates of Buyer shall become effective during any adjustment period; provided, that whenever the Annual Index shall be not more than thirty (30) points above the level indicated by said Annual Index on December 11, 1945, or whenever Buyer shall have effective rates equal to or less than 25¢ per Mcf, the prices provided in Section 1 of this Article VIII shall again be in effect. Whenever the Annual Index shall be more than thirty (30) points above said level, Buyer shall diligently pursue all rights and remedies to which it is entitled in a good faith endeavor to bring about, and procure the approval of, an increase or successive increases, as the case may be, in its rates to bring its rates up to the inflated price level. Buyer shall notify Seller in writing within ten days after receipt by Buyer of any revision during any adjustment period in rates for gas sold by it for resale. The term "adjustment period" as used in this Section 2 means the period beginning on the first day of the calendar month following the publication of the Annual Index showing such index to be more than thirty (30) points above the level indicated by said Annual Index on December 11, 1945, and ending on the first day of the calendar month following the publication of the Annual Index showing such index to be less than thirty (30) points above said level. For the purpose of applying the provisions of this Section 2, (a) the effective rates shall be deemed to include only rates for gas sold for resale, and (b) the price of gas delivered hereunder as provided in Section 1 of this Article VIII shall be deemed to be the price provided in said Section 1, exclusive of the provisions relating to the weighted average price of gas in the Panhandle Field and the Hugoton Field. In the event Buyer's rates for gas sold for resale shall not be uniform the effective rates for such sales shall be

deemed to be the weighted average price received by Buyer for all such sales during each calendar month. If for any calendar year an Annual Index is not published on or before April 1 of the following year, the Annual Index shall be deemed to be the arithmetic average of the monthly indices for the twelve months of such calendar year and shall be deemed to have been published in March